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In the Supreme Court of the United States

OCTOBER TERM, 1972

NO. 72-
72-437

JOHN A. MADER, ET AL.,
Petitioners

v.

DANIEL E. ARMEL, ET AL.,
Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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THE JUDSON-BROOKS COMPANY—CLEVELAND

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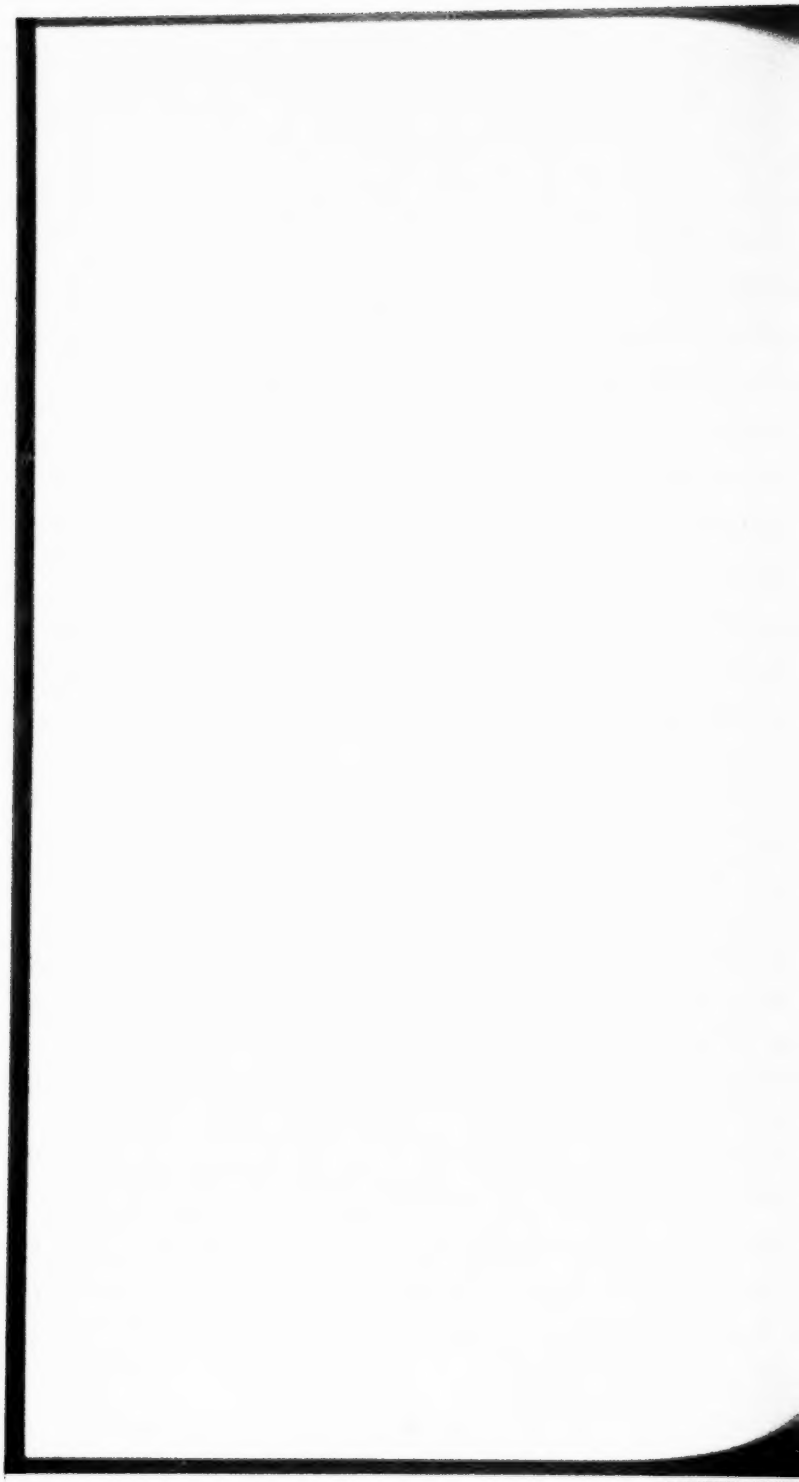

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DANIEL E. ARMEL, ET AL., RESPONDENTS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit entered in the above case on June 15, 1972.

OPINIONS BELOW

The opinions of the District Court for the Southern District of Ohio (Ap. 2) and the Court of Appeals for the Sixth Circuit (Ap. 32) are not as yet reported. Prior litigation in this case as to other issues not raised here is reported at 402 F.2d 158 (Sixth Cir. 1968).

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was made and entered on June 15, 1972 (Ap. 2), and a copy thereof is appended to this petition in the Appendix at p. A-32. The jurisdiction of this Court is invoked under 15 U.S.C. Section 78aa.

QUESTIONS PRESENTED

This action results from a merger of two Ohio corporations, approved by their respective Boards of Directors

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and shareholders. Shareholder approval was based on a fraudulent proxy statement, and Board approval, accomplished by the cunning of inside directors common to both Boards and the inattention of outside directors.

Inside directors dominated the Boards and drew up the fraudulent proxy statements; they were held liable by the District Court. The non-officer directors (respondents here) were unaware of the fraud (as they were neglectfully unaware of almost all corporate affairs) and, having never read the proxy statement, were held not liable under Section 20 (a) of the Exchange Act. The District Court found that

> none of them did anything to ascertain the real facts . . . no outside director made any effort to ascertain the details of the transaction . . . each outside director, including, of course, the outside directors defendants in this case, relied implicitly on the legal expertise of DeVennish and the accounting expertise of Hathaway & Hathaway and the financial expertise of Armel.

On appeal the Sixth Circuit Court of Appeals affirmed the District Court, holding the findings of fact of the lower Court not "clearly erroneous," and holding that the determinations of "controlling person" and existence of direct or indirect inducement of acts constituting the violation are questions of fact as to individual directors. However, the facts upon which petitioner relies are not in dispute, but are set forth in the District Court opinion. Granted that the question of control is one of fact, it becomes a question of law when the admitted facts are sufficient to establish control. The following questions are presented:

1. Is a director who votes for a resolution to approve a proposed corporate merger and to submit the proposal to the stockholders for their adoption "a controlling per-

son" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934?

2. Does a director who votes for a merger which is subsequently accomplished by a proxy statement which violates Section 10 (b), and who makes no effort to see the proxy statement or to ascertain the true facts concerning the merger, directly or indirectly induce the acts constituting the violation so that a good faith defense is not available to a 10 (b) cause of action?

3. Can a director establish good faith based upon ignorance resulting from failure to exercise ordinary diligence in discharging the responsibilities of a director?

STATUTES, FEDERAL RULES AND REGULATIONS INVOLVED

The federal statute pertinent to this petition is Section 20 (a) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78t).

Section 78t. Liabilities of controlling persons

(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person.

The Ohio statutes relevant here are Ohio Revised Code Section 1701.59 (A), providing in pertinent part:

> Except where the law, the articles, or the regulations require action to be authorized or taken by shareholders, all of the authority of the corporation shall be exercised by its directors.

and Ohio Revised Code Section 1701.78 (D), providing in pertinent part:

> To effect the merger or consolidation, the agreement must be approved by the directors of each constituent corporation, and adopted by the shareholders . . . .

STATEMENT

This action is based upon the damage to Certified Mortgage Corporation (Mortgage) shareholders from its merger into Certified Credit Corporation (Credit). As required by Ohio law, the merger was approved by both boards of directors and adopted by both groups of stockholders. The Mortgage stockholders adopted the merger in response to a joint Credit-Mortgage proxy statement which the District Court found to be fraudulent in material respects.

Credit and Mortgage had officers and directors in common, and Credit was in control of Mortgage. The fraudulent proxy statement was prepared and mailed under the direction of certain common officers and directors. The District Court found them liable.

None of the Respondents (Young, Patton, Bolovan, Tibbals) participated in the preparation of the Proxy Statement, and none of them saw it before the Proxy Statement was mailed. However, each of the Respondents received a copy of the Proxy Statement through the mail when it was sent to the shareholders.

The merger agreement, which was included with the Proxy Statement, contained the usual language that the "merger may be abandoned by the directors of either of the constituent corporations."

Young and Patton were long-term directors of Credit. Bolovan was a paid vice-president as well as a director. Tibbals joined the Board in June, 1959. The first meeting he attended was the one at which the merger proposal was approved. All four respondents continued as directors after the merger, during which time $400,000 more was collected from Mortgage shareholders upon subscriptions, and they were still on the Board when Bankruptcy intervened.

Young, Chairman of the Executive Committee, was found to be a controlling person. However, he (as well as the other respondents) was held to have established the defense of good faith, and it was further held that in the action of respondents in voting to approve the merger

> none of them did anything to ascertain the real facts . . . no outside director made any effort to ascertain the details of the transaction . . . each outside director, including, of course, the outside directors defendants in this case, relied implicitly on the legal expertise of DeVennish and the accounting expertise of Hathaway & Hathaway and the financial expertise of Armel.

Respondents were not held liable under Section 20(a). On appeal the Sixth Circuit Court affirmed.

REASONS FOR GRANTING THE WRIT

The decision below should be reviewed because of its erroneous interpretation of Section 20(a) Securities Exchange Act of 1934 and the negative effect of such interpretation of the regulatory scheme in the securities field, and because the affirmance of the District Court puts the Sixth Circuit in direct conflict with the holding of the Seventh Circuit in *McKy* v. *Hochfelder*, United States Courts of Appeals, Seventh Circuit. No. 71-1272, April 12, 1972, which is now before this Court on petition for certiorari.

1. Definition of terms in the Exchange Act is a matter of federal law. However, in determining whether a director is a controlling person within the federal definition it is proper to look at his relationship to the corporation under state law.

Ohio Revised Code Section 1721.59A provides in pertinent part:

> Except where the law, the articles, or the regulations require action to be authorized or taken by shareholders, all of the authority of the corporation shall be exercised by its directors.

No regulation has been adopted specifically for Section 20. However, Rule 12b-1 defines "controlling" as meaning "possession directly or indirectly of the power to direct or cause the direction of management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

We are not here faced with deciding whether a director is under all circumstances and for all purposes a controlling person. In our case directors voted on action which necessitated a proxy statement and without which a merger was impossible. In view of their power under Ohio law, it seems inescapable that the directors who voted to take the action "directed or caused the direction" of Credit and Mortgage in pursuing the merger and were, in that circumstance and as to the issues of this case, controlling persons.

It was argued below and held by the District Court that the respondents were not controlling because they permitted Armel to dominate the board. This is a confession that one director dominated these respondents in their exercise of control; it is not a denial that these directors exercised legal control in approving the merger and passing it to the stockholders for adoption. The directors clearly had the power, as well as the duty to control. The *de facto* abandonment of their power left them still clothed

with the *de jure* power and responsibility, and as to the specific actions they took which set in motion the proxy statement and the merger, they were controlling persons.

The facts of the instant case total gross negligence by any standard. As directors of Credit the respondents voted to approve the merger and cause it to be submitted to shareholders for adoption without any knowledge as to the financial state of either company.

The Seventh Circuit Court of Appeals recently held a stock brokerage firm a controlling person over its officers, and held it liable for the fraudulent acts of its President under Section 20(a) of the Securities Exchange Act. *McKy* v. *Hochfelder, supra.* The firm, in its failure properly to supervise mailing and billing practices, was held not to have acted in good faith and could not escape liability under Section 20(a). The Court cited *Myzel* v. *Fields,* 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied.* 390 U.S. 95 (1968), which urged liberal construction of the statute and required "only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." The controlling person must show that he took some precautionary measures to prevent the injury to avoid liability. *Lorenz* v. *Watson,* 258 F. Supp. 724, 732 (E.D. Pa. 1966). Failure diligently to supervise constitutes participation in the wrong by the controlling person who did not perform his duty to prevent it. *Hecht* v. *Harris, Upham & Co.,* 283 F. Supp. 417, 438 (N.D. Cal. 1968), *Modified on other grounds,* 430 F.2d 1202 (9th Cir. 1970).

The decision below is in direct conflict with the *McKy* decision. The District Court said:

> The position of the plaintiffs is that the board necessarily has a right to control an officer such as Armel and that any member of that board therefore exercises "indirect control" over an officer and is responsible under 15 U.S.C. 78 t. To steal a phrase from

> Judge Friendly (401 F.2d 866), the consequences of such a holding "are frightening."

The Sixth Circuit affirmed the decision as "not clearly erroneous." The Seventh Circuit clearly has a different view. The *McKy* v. *Hochfelder* case is currently before this court on petition for writ of certiorari. Petitioners respectfully submit that writs should be granted and the cases considered together.

Shareholders and the public alike assume that directors are in control; this assumption nurtures the confidence the shareholder places in publicly held companies. Protection of this confidence is the crux of the securities laws, but the holding of the lower court as to control on these facts emasculates the very purpose of securities regulation.

2. The Court below did not adequately treat the question of direct or indirect inducement of acts constituting violation. The reasons for the ruling are unclear and petitioners question their validity. Each respondent voted to approve the merger agreement in question. Pursuant to the vote of the directors of the constituent corporations, and in compliance with express requirements of Ohio Revised Code, Section 1701.78(D), the agreement was submitted to the stockholders of both corporations, the result of which was the merger out of which the present action arose.

Ohio Revised Code, Section 1701.78(D) provides in part:

> To effect the merger or consolidation, the agreement must be approved by the directors of each constitutent corporation . . .

The approval of the directors is essential to the merger. Without such approval, the merger agreement could not be submitted to the stockholders. No one director could by his vote alone cause or defeat the merger; but

each contributed his necessary part, and that should be enough. As a practical matter if any director had made a thorough analysis of the situation and used it to support a negative vote the merger might well have fallen through.

The violations found by the District Court occurred in the proxy statement. No respondent participated in its preparation or saw it before it was mailed. The question, then is, if the respondents induced the merger, did they also induce the fraudulent proxy statement, and if not, does Section 20(a) apply?

A proxy statement was the necessary sequel to the vote of the directors. It was, of course, prepared after the directors approved the merger. The merger articles were not filed for more than a month after the proxy statements were mailed. During this month the directors had the opportunity to study the proxy material and the power to abandon the merger. None of the respondents bothered to read the proxy statement, but this does not alter the fact that their failure to act after the proxy material became available was another link in the chain tying their vote to the fraudulent proxy statement which induced the merger.

In the case of a fiduciary whose acts are essential parts of a sequence of events, voluntary ignorance should no more break the causative chain than it should establish good faith (as will be discussed under question 3). The approval of the directors, which was recited in the proxy material, was in this case and customarily is the only information other than the proxy material upon which the shareholders base their judgment in voting. It would seem that the vote of a director to approve a merger agreement was a direct inducement of the proxy statement and the merger but in any event it seems inescapable that such an act at the very least was an indirect inducement.

In the context of the regulatory scheme, it is not an undue burden upon directors to hold them as direct causative forces of the actions caused by their votes, regardless of their knowledge or intent. On the other hand, to deny shareholder reliance upon director action unless the director has acted purposefully with full knowledge of the circumstances is to burden the investor with a risk he cannot possibly guard against in order to protect directors against risks they can guard against simply by doing what they are supposed to do.

3. Good faith of a director based on ignorance when that ignorance is a result of his own substantial neglect of duty should under no circumstances establish good faith.

The Court of Appeals was clearly wrong in their analysis as to this issue, and such interpretation has dangerous implications for the future of securities regulation. The respondents in the instant case were confronted with a situation which called for examination of the circumstances and thorough questioning of the inside directors. Had they exercised ordinary care, they would have prevented the loss which their negligence permitted. Their liability is clear.

Respondents base their defense on their own negligence: a decidedly novel position. In effect, they call their neglect of duty good faith. Because their negligence was not exercised in bad faith, they argue, it was by definition an exercise of good faith.

Respondents' actions did not exemplify good faith. None of their actions are indicative of concern for the corporate welfare. Respondents did not err in judgment in good faith; they did not make judgments regarding the corporation, they made judgments only regarding Armel, legal counsel (who was director, secretary and counsel of both companies) and the accountants, whose lead they

blindly followed. They ignored the responsibility of evaluation which is the basis of a judgment. A deliberate avoidance of the duty to exercise judgment disqualifies a director from the protection he would have had, had he tried to decide on the best action and erred in his decision to the detriment of the corporation.

A director's duty of care requires some measure of awareness, concern and thought. Absolute reliance upon accountants, lawyers and board chairmen is not the exercise of care. Directors may not give proxies, but the decisions below permit what in effect is a blanket proxy to the Chairman of the Board.

Respondents' abdication of duty may, in itself, be bad faith. The purpose of the office demands attention to corporate affairs; if a director can perform duties whimsically there is no reason for the office. The existence of insiders on a board does not excuse the outsiders from directing; if anything, it increases the outsider's watchdog duty.

CONCLUSION

For the reasons set forth above, it is respectfully submitted in this petition that a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

15 USC § 78aa. Jurisdiction of offenses and suits

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

28 USC § 1254. Courts of appeals; certiorari; appeal; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

(2) By appeal by a party relying on a State statute held by a court of appeals to be invalid as repugnant to the Constitution, treaties or laws of the United States, but such appeal shall preclude review by writ of certiorari at the instance of such appellant, and the review on appeal shall be restricted to the Federal questions presented;

(3) By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instructions are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy. June 25, 1948, c. 646, 62 Stat. 928.

MEMORANDUM OPINION

(Filed January 25, 1971)

This case is a class action and is based on 15 U.S.C. 78j, Rule 10b-5 of the Securities and Exchange Commission, adopted in pursuance thereof, and 15 U.S.C. 78t. Jurisdiction is based upon 15 U.S.C. 78aa.

The plaintiffs were shareholders in an Ohio corporation named Certified Mortgage Corporation, which merged, in 1959, with another Ohio corporation named Certified Credit Corporation (respectively referred to hereinafter as "Mortgage" and "Credit"). Credit was the resultant of the merger. The general background of this case is set forth in *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968) and will not be repeated here.

Subsequent to that Court of Appeals decision, the appropriate action required by Civil Rule 23 (class actions) was taken. And in the course of these proceedings, at one time or another, the members of the class have been determinated to be those individuals or entities which owned any type of stock in Mortgage at the time of the merger in December, 1959. As a result of that determination, evidence was limited to occurrences which took place either before that time or shortly thereafter. At the time of the merger, there were in existence stock subscriptions in Mortgage involving an amount in excess of one-half million dollars, a substantial portion of which was paid to Credit after the merger (in accordance with the terms of the Merger Agreement, attached to Plaintiff's Exhibit 3). There were communications between various of the defendants and Credit on the one hand and these subscribers on the other hand after the merger. Because of that the plaintiffs urged the relevancy of those communications. The December, 1959, boundary was adopted by this Court for two reasons:

(a) The matter seems to have been decided in the Circuit opinion under the heading of "Stock Subscriptions."

(b) When shares were purchased on subscriptions in Mortgage, the downpayment always involved enough to purchase at least one share of stock; at such time the subscriber-stockholder's name was entered upon the shareholders ledger of Mortgage. As a consequence, the stockholder-subscriber received communications from the company to the same extent as any other shareholder.

After the class had been determined and a substantial number of the members had 'opted out, the plaintiffs and the defendants Kent, Cowles, Nolte, Kirk and Eaton settled the questions involved in this controversy on due notice and approval.

15 U.S.C. 78j provides, insofar as relevant herein, as follows (under the title, "Manipulative and deceptive devices"):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails * * * to use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Pursuant to that section, the Commission has adopted and promulgated what is known as Rule 10b-5 (17 C.F.R. § 240.10b-5) which provides, insofar as applicable here, as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of * * * the mails * * *
>
> (1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,

(3) to engage in any act, practice or course of business which operates or would operate a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Any question of the applicability of the statutory and rule provisions to a merger and particularly to this merger has been set at rest by *Mader* v. *Armel, supra.* The general effect could be summarized in this fashion: The 1959 merger involved a sale by Credit to the Mortgage shareholders of Credit's stock and a purchase by Credit from the shareholders of Mortgage of their Mortgage stock.

Also very much involved in this case both affirmatively from the plaintiff's point of view and defensively from the defendant's point of view is 15 U.S.C. 78t, entitled "Liabilities of controlling persons." That section provides, insofar as pertinent here:

"(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule * * * thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

"(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule * * * thereunder through or by means of any other person."

Certified Credit Company was an Ohio corporation. For purposes of this case it commenced its operations in 1950. It initially engaged solely in the small loan business and that business, generally speaking, remained its backbone. It subsequently opened up a number of small loan offices in Ohio and elsewhere and, in addition, throughout its life, it acquired, through stock issues, mergers, etc., other loan companies and credit unions. In 1957, it branched out investmentwise, as distinguished from direct operationwise, into various insurance fields, mainly through acquiring control of small insurance companies. By 1959, its direct and associated operations were carried on in Ohio, Indiana, Alabama, Massachusetts, Louisiana, Arkansas and Texas. Its "on paper" growth was somewhat phenomenal. For instance, its balance sheet in the finance company area in 1950 was less than $200,000; in 1959, it was over $9 million. Its affiliated insurance—whether one calls them investments or indirect operations—went from a zero balance sheet in 1957 to something in the neighborhood of $4 million in 1959 on paper. During its lifetime, which extended from 1950 to 1961, it raised capital funds in excess of $6 million, predominantly from stock and the sale of thrift certificates or debentures, or the sale of stock in subsidiaries. At least on paper these stock sales were intrastate in character. To further complicate matters, the so-called "investments" in insurance operations were by and large not directly in the regulated type of insurance company; or stated otherwise, were not directly related to companies which actually did insuring. These investments were in companies which were nonregulated but which, on the other hand, controlled affiliated insurance companies. At one time or another, the parent, Credit, was related or affiliated with and controlled (either via stock ownership or management contract or control stock position) some 20 or 30 other companies—Mortgage as an example, as we shall see. For

our purposes, by and large, the companies other than Credit involved in these intercompany relationships had no employees as such. The management of Credit furnished itself and its Credit employees to these various related companies, did what the management and the employees of these related companies normally would have done had they had management or employee personnel; periodically the "parent" charged these related companies for these services. Whether these charges were "out of thin air" or "related to the facts" was somewhat of a controversy in this case, which is not deemed to be important. However these charges were determined, the charges when made appeared on the books of the parent in one fashion or another as an asset—either as a "receivable" or as an "investment" or as a "long-term receivable." To the extent that the charges would appear as "investments," the method was by capitalizing the charge or adding it to whatever the then cost of the particular investment might be. Through the entire life of this company and its affiliates, not one cent of these charges was ever paid to the parent by any subsidiary or affiliate (with one possible exception and that was a bookkeeping accident). The capitalization to investment was, of course, totally unwarranted. There is no real argument on this record that the charged companies were never in any position to pay, nor is there any argument that if a company involved in the "investment" addition method had liquidated nothing would have been realized in respect of any company upon that part of the charge which had been capitalized. The net effect was to render false the statements of Credit not only insofar as cash and receivables, investments and long-term receivables were concerned, but also the portions of the statements dealing with surplus and earnings. For instance, limited to the intercompany charges taken into income via the receivable method—in 1952 this amounted to approximately $60,000. In 1957 that had grown to approximately $400,000 and it went up approximately $100,000 a

year thereafter during the period of interest here. The published statements of Credit in 1958 and 1959 were, in broad conclusion, at least 40 percent false and any correct statement, by generally accepted accounting methods, would have indicated Credit in 1959 was hopelessly insolvent and losing money hand over fist.

Shortly after Credit entered the insurance field and as a result of some preliminary skirmishing with the S.E.C., it became at least impracticable for Credit to obtain any additional capital funds through the sale of its own stock. The company and its management at that time did, unquestionably, have quite a favorable reputation in the Central Ohio area. Credit was growing by leaps and bounds, based on its published statements, and the snowball continued to roll down the hill. That situation lead to the incorporation of Mortgage. It also lead to the incorporation of an Ohio corporation named Commonwealth Securities, Inc. (hereinafter called "Securities"). The published purpose of Mortgage was the furnishing, through it, a vehicle through which the well-known Credit company could enter into the real estate mortgage field. Mortgage, like its parent, was to have two classes of common stock, one of which, A, would be sold for approximately $10.00 a share; the other of which, B, would be sold for a few cents a share. A substantial amount of the B stock was to be acquired by Credit. The shares voted equally. This method of exercising control over a subsidiary or affiliate was well established in the Credit operation and the method included itself. In other words, Credit, too, had A and B shares outstanding—the A cost a relatively substantial amount of money and the B cost a few cents, and both voted equally. Commonwealth Securities was to be and did become the underwriter of Mortgage's stock. The underwriting fee was substantial.

Two issues and underwritings of Mortgage stock took place—one in 1958 and one in 1959—as a result of which

approximately 300,000 shares of A stock were sold or subscribed for. In other words, the public investors who invested in the A stock contributed in capital funds to Mortgage approximately $3 million, less the underwriting fees. Approximately 40,000 shares of B stock were purchased by the parent, Credit, at 10 cents a share, and represented an investment of some $4,000.00. Of the capital funds realized by Mortgage, $1,700,000 was invested in thrift certificates or debentures issued by Credit—or stated otherwise, of the actual cash realized by Mortgage from the issue of its own stock during its life, less unpaid subscriptions and less underwriting fees, more than two-thirds found its way into the capital (debentures) of Credit. With one exception involving a $300,000 loan to a company known as Columbus Trotting Association and subsequently as Scioto Downs (a trotting track), which was a somewhat related operation, and with one other possible exception, Mortgage never did any mortgage business at all—its sole business was raising capital for Credit.

Before describing the merger and the proxy solicitation which furnishes the basis for this case, it would be well to digress and describe the relationships of the various individual defendants with Credit and Mortgage. The founders of Credit were the defendant Daniel E. Armel, who served it as president and director through its lifetime; and Marshall B. Dewey, who served it as chairman of its board and director at least through most of its lifetime. There is not a great deal in the record in this case with respect to Dewey. There is a considerable amount in this record in respect of Armel. It could be and is summed up in the language of Chief Judge Weinman at the sentencing in a criminal case related to this case as follows:

> "The dominant force without any question behind the Certified Credit Corporation was Daniel Armel. * * * He functioned as President and the Chairman of the

> Board. Regardless of title, Armel was Certified's chief executive officer; he was able to exercise control of the Board of Directors and the Executive Committee, as well as other corporate officers."

De facto, Certified Credit was a "one-man show." All of the directors had implicit confidence in Armel and at least insofar as what might be called the outside or non-employee directors, none of them had any reason to doubt their confidence in him until after the events which are determinative in this case.

The defendant DeVennish is a lawyer admitted to the Ohio Bar about 1945. He was secretary, director and general counsel of Credit since it was founded, was a director and general counsel for Mortgage and was an officer and director of a number of the companies affiliated with Credit. Mr. DeVennish was an outside retained counsel.

The defendant Savage was the treasurer of Credit since 1955. He was a director of both Credit and Mortgage and had been associated with the Southern Ohio accounting firm of Hathaway & Hathaway prior to his association with Credit. In the criminal case to which we have referred, Savage was a defendant and pled guilty to Count 1 in the indictment in that case. Count 1 included a great many charges, one of which in essence charges exactly what the amended complaint in this case charges.

The defendant Tibbals is an architect by profession. He first became associated with Credit in 1959; he never attended or had occasion to attend any directors' meeting of either Credit or its affiliates until November 16, 1959, just 12 days before the proxy solicitation was mailed. There is no evidence in this case — looking at it most favorably for inference purposes on behalf of the plaintiff — that would justify any conclusion that Tibbals either knew there was anything wrong or should have known that there was anything wrong, or in any way, factually or

legally, controlled anyone who knew that or was in combination for any purpose with anyone who knew or should have known that anything was wrong. He was dismissed from this case on motion at the end of the plaintiffs' case and that dismissal should be formalized in any judgment entered in this case.

The defendant Patton is a manufacturer from Springfield, Ohio. He first became connected with Credit in 1953 on his election to the board. The defendant Bolovan was at all times an operations man. While he was a full-time employee of the company and was a director of Credit, as well as Mortgage, and bore the title of vice president in charge of finance – nonetheless, his real field was operations. He had nothing to do with finance as such. Like Patton, he had no knowledge of anything manipulative, nor did either of them, on the evidence in this case, have any reason to suspect any wrongdoing. Furthermore, neither of them was in any way a member of any group which could or did exercise any control excepting only that each was a member of a board, which board exercised control. One position of the plaintiffs is that the board necessarily has a right to control an officer such as Armel and that any member of that board therefore exercises "indirect" control over an officer and is responsible under 15 U.S.C. 78t. To steal a phrase from Judge Friendly (401 F.2d 866), the consequences of such a holding "are frightening." Be that as it may, and as to each of these defendants, Bolovan and Patton, it is found that each of them acted in good faith and, in addition, that neither of them directly or indirectly induced the falsifications or deficiencies in the proxy solicitation (15 U.S.C. 78t). The complaint as to each of them should be dismissed in any judgment entered in this case.

The defendant Young first became connected with Credit in the early 1950's and very shortly after its busi-

ness commenced. Young was then in his early 40's. He was an undergraduate of Ohio State University and received his Doctor of Medicine from Harvard. He was, and still is, a very busy and very successful general surgeon and, in addition to the demands of his professional practice, he has taught surgery at Ohio State University Medical School and supervised the operation of some family firms in Union County, Ohio. He has had no education in or experience with accounting matters or corporate financial matters. He had never been a director in what might be called an ordinary commercial company until he became a director of Credit. He and Armel had some passing acquaintance in school as youngsters. Armel also was a graduate of Ohio State, had achieved some prominence in the school editorial field while there, had spent some 15 or 16 years in the South and Southwest and returned to Columbus at about the time Credit was started. Armel, based on the early acquaintance, solicted Young's interest in Credit and it does appear from this record that Young and his family constituted the largest overall investor in Credit. In one fashion or another Young and what might be termed the more or less immediate members of his family invested overally in all of the related enterprises and in all the various types of capital issues some one-half million dollars plus. About one-fifth of this was in common stock of one type or another and the other four-fifths was in preferred stock and thrift certificates. The bulk of these investments were made prior to 1957 and the annual amounts were less thereafter. The change in tempo was related to the termination of a professional contract involving North American Aviation. Nonetheless, substantial investments were made in 1958 and 1959 by Young and his family and certainly there was no reduction in investments or withdrawal in either of those years. For some years prior to December, 1959, Young was not only a director of Credit,

but also the chairman of its Executive Committee. The office was more a paper one than anything else. There is no indication in this record that the Executive Committee interfered in any way with the de facto control of Armel. As has been pointed out, control over the Credit companies was exercised through a Class A-Class B common stock setup in which Class B voted equally with A, but was a "cheap stock." The design originally was to so preserve complete voting control for Armel and Dewey. As a matter of fact, Armel and Dewey had an option to buy B shares of Credit running into the millions of shares. Outsiders and specifically members of the public were not permitted to buy the B shares separately – generally speaking, the B shares which outsiders acquired resulted from sales of A and B as a unit. As Credit grew and these unit sales increased, Armel and Dewey were unable to purchase a sufficient number of B shares to retain control of Credit.

In 1953, and in order to assure the continuance of this control, a Voting Trust Agreement was entered into involving Armel, Dewey, DeVennish and Young. Young had been permitted to acquire B shares alone, as distinguished from a unit basis. DeVennish also owned some B shares. Under the Voting Trust Agreement, Dewey and Armel retained voting control of all the B stock of the four named. For reasons which are not clear on this record, in 1954 this Voting Trust arrangement was terminated and all of the B shares of the four persons above named, together with the option of Armel and Dewey to purchase additional B shares, was transferred to a company called Certified Investment Corporation. Each of the above named transferred to Certified Investment an amount of Class B shares of Credit proportionate, over-

ally, to his individual ownership in Investment. The percentages were as follows:

Armel	30%	Young	30%
Dewey	30%	DeVennish	10%

There was a tacit understanding between Armel and Dewey that their 60% would be voted as a block and that each had a first refusal right to purchase the 30% of the other, which extended to the other's estate in the event of death. As a matter of fact, shortly before Dewey died in 1962, he sold his 30% to Armel. The purpose, of course, of the Certified Investment arrangement was to insure the continued control by Armel and Dewey, so that there is no doubt on this record that Young and DeVennish joined with Armel and Dewey to constitute a group which controlled the action of Credit. In fact, those four individuals did constitute a control group as that language is used in 15 U.S.C. 78t. In addition, as has been noted, Commonwealth Securities was formed in 1957 or 1958 for the purpose of "making a market" for Credit stock. It proposed to engage in, among other things, the underwriting field. Armel brought two individuals into Ohio from Texas for the purpose of operating it. There was a starting requirement for its proposed operations of a minimum $25,000.00 in capital. That capital was provided wholly by Young. Initially half of it went directly to the company as a capital contribution from Young; the other half went to Armel as a loan and then from Armel to the company. The eventual result was the issue by the company of 25% of its stock to Young, 25% to Dewey and 25% to each of the Texans brought in to manage the company. This was the company which underwrote the sale of Mortgage's common stock to the public. (There were really two separate underwritings.) It was via this underwriting that the public purchased and the company obtained some $3 million in capital funds, less a substantial underwriting commission of approximately $300,000.

In 1959 Armel proposed to merge Mortgage and Credit. The stated reason (by Armel) was that instead of trying to develop the mortgage business through the mortgage company, it was financially advantageous to use the funds which had been raised for that purpose to buy some existing companies in the mortgage business and that these companies could better be acquired and operated as direct subsidiaries of Credit. Since Armel, based on the published performance to date, appeared to be somewhat of a financial wizard, there was no questioning of this purpose by anyone. An indication of the real reason can be seen by a look at the result. As has been noted, Mortgage had in fact invested in the neighborhood of a million and a half of its capital funds in Credit debentures. These debentures were subordinated and appeared on the Credit statements as capital funds. However, vis-a-vis stock, the subordinated debentures constituted a debtor-creditor relationship and in that sense the total debenture liability of Credit before the merger amounted to approximately $3 million. After the merger this liability appeared as only approximately $1,300,000. In effect, the result was to capitalize the million and a half; or stated otherwise, was to convert the shareholder classes of Mortgage from a million and a half creditor status vis-a-vis Credit's shareholders to a simple co-shareholder of Credit status. As a result of the proposal to merge, a Plan and Agreement of Merger was prepared and this Plan and Agreement of Merger was transmitted to the shareholders of Mortgage and Credit by mail as a part of a proxy statement, a letter of transmittal and a proxy and notice of shareholders' meeting. The proxy statement was a joint one on behalf of both companies. The mailing date was on or about November 28, 1959. The shareholders' meeting date was December 10.

The particular terms of the agreement of merger are not of particular significance. In a nutshell, all of the

assets of Mortgage were to be transferred to Credit; Credit was to assume all of the liabilities of Mortgage; the shareholders of Mortgage were to surrender their stock and receive in exchange therefor stock of Credit. At the time of the merger, in addition to the debentures, Mortgage had assets consisting of two mortgage loans amounting to approximately $365,000.00 which eventually proved good and were paid and, in addition, it had an asset titled "Unpaid Subscription" which amounted to some $600,000 plus, on which eventually some $400,000 plus was realized. Nor were the debentures themselves valueless at that time. After several more years of mismanagement and a bankruptcy, some small dividends were paid on the Credit debentures. While the sole oral evidence in this case of damage as the result of the merger was to the effect that the only fair way to value Mortgage stock at the time of the merger was on a liquidating basis and its liquidating value was not affected by the merger, that testimony cannot be accepted in the light of the facts above referred to. In December of 1959 there was some demonstrable liquidating value to Mortgage stock before the merger. After the merger, the Credit company, on any liquidation, would have distributed nothing to its shareholders. (See S.E.C. Exhibit referred to in this record as 13.) Accordingly, conceding the plaintiff, in a case such as this and in a trial of the severed issue of liability, has the burden of showing some damage resulting from the merger (see *Mills* v. *Electric Auto Light*, U.S. (1970), Part 3), the plaintiff in this case has satisfied that proof requirement by a preponderance.

Two matters should be dealt with before attention is directed to the proxy solicitation directly—

First – from the time of its formation, the records of Credit (and subsequently of the other companies involved) had been kept under the general supervision of a firm of

Certified Public Accountants – Hathaway & Hathaway – which firm had offices at least in Cincinnati and Columbus, Ohio. The annual statements were prepared and certified by that firm of Certified Public Accountants. In addition, monthly statements were prepared. It does not appear whether these monthly statements were prepared by that firm. These monthly statements (referred to in this record as "blue lines") have been examined. The form of the monthly statements is generally consistent with the form of the annual statement and it is a reasonable inference that these blue lines also are attributable to that accounting firm. During the times of interest in this case, that firm was duly certified by the State of Ohio as authorized Certified Public Accountants to report on examinations and certify the results. Year by year, these reports to the board of directors of Credit were made by that firm. This accounting firm, which had a good reputation at the time and was well recognized, repetitiously reported to the board of directors of Credit that at least their annual examination "was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such auditing procedures as we considered necessary in the circumstances." The certifying letter dealt specifically with the items booked as "Investments and advances to subsidiaries" and in each case concluded, after multi-page comments and multi-page statements, with the following:

> "In our opinion, subject to the foregoing comments, the accompanying balance sheets and related statements of income and expense and surplus present fairly the financial position of Certified Credit * * * and the results of their operations for the year then ended, in conformity with generally accepted accounting principles * * *."

In the reports, certified by the accountants, the subjects of investments and advances to subsidiaries were specifi-

cally dealt with in a fashion which would lead a reader to the conclusion that the usual test for accuracy, accountwise, had been applied to these assets and satisfied by applying them in conformity with generally accepted accounting principles. There was, for instance, no statement such as this:

> "In 1952 this company advanced some $62,000.00 to two subsidiaries totally owned by it. These advances are presently shown on the company's books as a receivable in the amount of $62,000.00. Not one cent has been paid on this obligation during the seven years of its existence. Your accountants have made no effort to ascertain whether these subsidiaries have ever had or have now the ability to pay all or any part of this receivable. The collectibility has been merely assumed and that assumption results in increasing the income account of this company by $62,000.00 and that increase is reflected in the present surplus. The same is true of the other capital advances to the other companies which now (in 1959) amount to in excess of $800,000.00. In addition, there is included in this balance sheet as investments in affiliated companies and subsidiaries some $3,000,000.00. A substantial amount of that represents advances made by this company to its affiliates and subsidiaries for current operating expenses. Not one cent has ever been repaid. The advances have been capitalized by adding the amounts involved to the book value of the particular investment. No examination has been made to ascertain whether the facts warranted the capitalization."

While the outside directors (i.e., those not employed by Credit as officers) who testified in this case, each disclaimed ever having seen either the blue lines or the annual reports of the Hathaway firm, there is no question that the form of report submitted to the directors at directors' meetings, as well as the form of the published reports of the company, were based on the Hathaway statements. They were abbreviations. For example, the published statement for 1959 for Credit, insofar as a bal-

ance sheet was concerned, was a one-page affair listing as assets "Cash and Receivables" lumped together in the amount of approximately $3 million and "Investments and Long-term Receivables" also lumped together in the amount of approximately four and one-half million dollars. These figures were the resultant figures in the Hathaway report and the published figures contained in the Annual Report of the company – each contained on its face and in a prominent one-page style the Hathaway certificate in the form referred to above. In net effect, since each director conceded knowledge of the annual report, the abbreviated statements which the directors had viewed at directors' meetings of Credit were entirely consistent with the annual statement contained in the annual report, which included a certificate of "testing" and "conformity with generally accepted accounting principles."

One of the claims of the plaintiffs directed to the merger proxy is that it was false and misleading in that it lumped cash and receivables together rather than breaking them down. Had they been broken down, it would have appeared that the cash actually amounted (in the 1959 figures) to some $42,000.00 and the receivables to $2,885,000.00 approximately. In net effect, this would have shown on the face of the statement that the cash on hand was less than a month's operating expense. That the method of presentation was deceptive cannot be denied objectively. However, Armel did have what appeared to be a reasonable explanation for the shortness in cash at any time it was questioned by a director – his point being that a finance company was in the business of keeping its cash at work and the smaller the amount on hand, the more that purpose was being served, and, secondly, the method of treatment had been underwritten in the accountants' published statements.

Before leaving these accountants – this record affirmatively indicates that at the Credit directors' meeting dealing with the merger, a Credit director questioned whether the exchange as proposed in the merger was not too favorable to Mortgage. That director and the other members of the board were told by Armel that the proposed exchange would be checked into and verified by Hathaway & Hathaway on a "market basis" so that, in net effect, at the very happening of the events which gave rise to this case, the Credit directors were informed by Credit management, in addition to what appeared in the accountants' certificates, that the accountants were knowledgeable on a market or real value basis.

The second matter to be dealt with is this: Just who were members of the board of directors of Mortgage. There is no doubt that Armel, Savage, Bolovan and Dewey were. Nor is there any doubt that DeVennish was. Four, therefore, out of the five claimed inside directors and the counsel of the company were clearly shown to have been directors of Mortgage at the time of interest here. One inside director, an insurance vice president, while claimed to have been a director according to the minutes, flatly denied that he was ever informed of his election. Every outside director of Credit, claimed by the plaintiffs to have been a director of Mortgage, who testified in this case (at least four), flatly denied ever being notified of their election as a Mortgage director. Some conceded that they had been told that they were going to be and expected to be. There was considerable newspaper publicity in the areas in which these directors lived and in connection with the stock sales of Mortgage, naming these outside individuals as directors of Mortgage and, in addition, they were described as such on the prospecti issued in connection with the two stock sales; also, one or more were connected by the evidence in this case with proxy returns for annual meetings of Credit, etc. It was clearly

established in this case that the minute book of Mortgage in certain respects had absolutely no relevance to actual fact. For instance, Young is shown in the minutes to have been present at at least three directors' meetings when he was unquestionably at least 500 miles away from the meeting place. It would be a fair conclusion that the minutes of Mortgage were falsified by the same management which had no hesitancy in falsifying its accounting records. The plaintiffs have not borne the burden of establishing that any of the defendants in this case, other than Armel, Savage, DeVennish and Bolovan, were directors of Mortgage. There is no doubt that all of the other defendants in this case were directors of Credit in 1959 when the proxy solicitation was mailed.

To return to the proxy solicitation —

The plaintiffs have established that the proxy solicitation material, which included the proxy statement, a transmittal letter and a notice (the one signed by Armel and the other signed by DeVennish) and a proxy were mailed to the shareholders of record of both Credit and Mortgage in November of 1959. The proof relied on was more circumstantial than direct due to the fact that a great many of the company records had been turned over to one or the other government agency and that, coupled with the erosion of time, prevented direct proof. The circumstantial evidence, however, was adequate and based thereon it is found that the proxy statement was mailed as claimed by the plaintiffs.

In determining whether the proxy statement "made any untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading," this Court is applying to the various claims of the plaintiffs the tests for materiality stated in *List* v. *Fashion Park*, 340 F.2d 457 (2nd Cir. 1965) as follows:

"The basic test of materiality is whether a reasonable man would attach importance, * * * in determining his choice of action in the transaction in question. This, of course, encompasses any fact * * * which in reasonable and objective contemplation might affect the value of the corporation's stock or securities."

The material misstatements and omissions in the proxy solicitation material included the following:

(a) It was stated that the boards of directors of both Credit and Mortgage deemed the merger advisable and had approved the proposed agreement; while the proxy material did state, "The management of Credit may be considered to be in control of Mortgage," it did not disclose the fact that each member of the board of directors of Mortgage was a member of the board of Credit.

(b) The proxy material indicated that Mortgage was a "subsidiary" of Credit. It did not disclose that in excess of $1,200,000.00 of Mortgage's capital had been paid by the public and only something in the neighborhood of $4,000.00 had been paid by Credit; nor did the proxy statement disclose how many shares of Credit or Mortgage the board members of Credit and its officers owned—and without regard to who is considered to be on what board. There simply was no disclosure that the people who controlled Credit had a substantial stock interest in Credit and practically no stock interest in Mortgage. The proxy material simply lead the reader to believe that an independent board of Mortgage had considered and approved the merger. In fact, to whatever extent Mortgage had a board, members thereof had no shareholding interest in Mortgage as such, but were heavily interested in Credit.

(c) The proxy material indicated that DeVennish was counsel for Credit. It omitted to state that he was also counsel for Mortgage. Once again, DeVennish had a substantial stock interest in Credit and, insofar as this record shows, no stock interest in Mortgage—that was not disclosed.

(d) The proxy material claimed for Credit as of the date of the proposed merger a surplus of some $586,000. With respect to that claimed surplus, it omitted any reference to whether the claimed surplus was earned or paid in, and affirmatively stated a falsehood, since in fact the company at that time, for the reasons indicated, actually had a deficit.

(e) The proxy material listed under the headings of "Cash and Receivables" and "Investments and Long-term Receivables" for Credit a total exceeding $5,000,000.00. That was false by at least 40 percent. Many of the investments and receivables had little, if any, value and that included amounts related to advances to subsidiaries above described.

(f) The proxy statement claimed that Mortgage began business in April of 1958 and indicated that its principal business had been loaning money secured by mortgages on real estate and otherwise acquiring and dealing in mortgages and other investments in real estate equities and securities. In other words, the statement was that it had been engaged in the real estate mortgage business. That was false. Insofar as this record indicates, it had apparently made only two real estate loans, each to a company with which the defendant Young was connected in one capacity or another. (It should be noted that both of those were good loans and were eventually paid, at a profit to Mortgage.) Actually Mortgage's principal activity had been to "invest" in Credit's subordinated debentures. Some million and a half dollars, in excess of one-half of its capital funds, had actually been so invested at a minimum prior to the merger. The proxy statement omitted to disclose actual facts such as this: that Mortgage had principally been a conduit through which Credit had obtained additional capital funds.

Each of the statements and omissions above described was material, as above defined. There were in fact other misstatements and omissions in the proxy solicitation not considered material by this Court.

The proxy solicitation material, and specifically the statement, was prepared by Armel and DeVennish jointly. No other director of either Credit or Mortgage actually saw the proxy statement prior to the time of its distribution and there is no evidence that any of the outside directors actually read it at any time. The outside directors did know, as well as the inside directors, that Credit was acquiring the assets of Mortgage through a merger and a stock issue. No outside director made any effort to ascertain the details of the transaction. Each outside director, including, of course, the outside directors defendants in this case, relied implicitly on the legal expertise of DeVennish and the accounting expertise of Hathaway & Hathaway and the financial expertise of Armel. There is no evidence in this case that any outside director actually knew that false statements had been included in the proxy solicitation. Specifically, there is no evidence at all that either Young or Patton knew either that the proxy solicitation was deficient or that the actual facts were different from the facts as stated in the solicitation. Insofar as actual fraud is concerned, it is the conclusion of this Court, based on all of the evidence in this case, that none of the defendants Young, Patton, Bolovan, or Tibbals did anything that was deceptive or manipulative. None of them did anything to ascertain the real facts, placing their reliance as above described. Even assuming the plaintiffs' burden to have been only by a preponderance, the plaintiffs failed to show by a preponderance of the evidence that Bolovan or Young or Patton or Tibbals had any "scienter."

As a result of the use of the proxy material, proxies necessary to the approval of the merger were obtained from the shareholders of Credit and also from the shareholders of Mortgage. The means by which they were obtained was the materially misleading solicitation. The

proxy solicitation itself was an essential link in the accomplishment of the merger.

The plaintiffs showed, by a preponderance, some damage as a result of the 10b5 violation. The only evidence in this case dealing specifically with the damage question was through an expert witness who testified that the most accurate way to value Mortgage stock prior to the merger was on a liquidating basis and that remained the same after the merger and presumptively they were the same. This Court does not agree for two reasons. In the first place, as already noted above, it has been indicated that the thrift certificates owned by Mortgage had some value and approximately $400,000.00 of its loans represented that in value, and whatever these values amounted to, they were lost to the Mortgage shareholders as a result of the merger. In the second place, there is a difference between the value of the Credit stock actually obtained in the merger and the real value which it would have had had the affirmative representations of the proxy statement been true.

Before turning to the legal conclusions applicable to the above, one defense—that of res judicata—was asserted as applicable only to the defendant Armel. In March of 1963 and just prior to the bankruptcy proceedings involving Credit, two of the three plaintiffs in this case, joined by some other plaintiffs, filed an action in this Court against Credit Commonwealth Securities and a number of other corporations and, in addition, Armel, Young and Savage. Like this case, that action was described as one brought under Sections 10b, 15 and 27 of the Securities Act of 1934. It was brought as a class action on behalf of all stockholders of Certified Credit, including those who had obtained their stock as the result of the merger of Credit with Mortgage. Essentially the action was a derivative one, allegedly derived through Credit—the basic claim being that the defendants had conspired to obtain control

of the assets of Credit basically through the A and B stock system and specifically through a number of devices and manipulations. The merger was described in paragraphs 45, et seq., as an act done in execution of the main conspiracy as was the merger proxy solicitation.

Shortly after the case was filed, and on April 2, 1963, Credit became a party to a Chapter 10 bankruptcy proceeding in this Court and promptly thereafter, the trustees entered the case and asked for a stay order. The general area of controversy was whether the action as filed was inside or outside the orbit of a Chapter 10, with the plaintiffs taking the position that some portions of the action as filed were non-derivative, were outside that orbit, and that at least as applied to such, the action should be permitted to proceed. In 1963 the action was stayed. An appeal was filed and voluntarily dismissed by the appellants. Thereafter, and in 1968, this Court, on motion of the bankruptcy trustees, entered an order in that case substituting the trustee "as nominal party defendant for the defendant Certified Credit Corporation." That order also provided, "The subsequent prosecution of this case for the benefit of said estate shall proceed under his control." The defendant Young was dismissed as a party by that order. Savage was thereafter dismissed without prejudice. Thereafter, and in 1969, an order was entered disposing of a motion by Armel to dismiss, which recited that "the within action be and it is hereby dismissed. Such dismissal shall be with prejudice. * * *"

With respect to this defense of res judicata asserted by Armel, the order in that case placing control of the litigation in the trustee for Credit, essentially determined that the matter would proceed only as a derivative case in which the controlling party would be asserting only derivative claims. The claims in this case are not derivative and were not disposed of in the previous litigation. Cf. *Simmons* v. *Wolfson*, F.2d (6th Cir. 1970).

The sole remaining fact question in this case is one of "good faith." Before reaching it, the conclusions of law of this Court are as follows:

(a) The proxy solicitation was used in connection with the purchase or sale of securities. Mortgage stock was purchased and Credit stock was sold in the merger. See *Mader* v. *Armel, supra* (6th Cir.).

(b) The proxy solicitation constituted a manipulative or deceptive device, contained untrue statements of material facts and, in addition, omitted the statement of material facts necessary in order to make the statements made not misleading in the light of the circumstances under which they were made. See *List* v. *Fashion Park*, supra. The proxy solicitation was in violation of 15 U.S.C. 78j and Rule 10b5.

(c) A causal relationship existed and exists between the violation and the injury sought to be redressed by this case. The proxy solicitation itself was in fact an essential link in the accomplishment of the transaction, since proxies necessary to approval of the merger were obtained by means of the solicitation. The evidence establishes that there was substantial proxy voting for the merger both by the shareholders of Credit and the shareholders of Mortgage — in addition, those voting in person had received and presumptively were influenced by the deficient proxies. See *Mills* v. *Electric Auto Light*, U.S. (1970).

(d) Armel clearly was aware of the misstatements in the proxy solicitation. Scienter, in the ordinary sense of the term, was clearly established as to Armel. For the reasons indicated above, the same is true of the defendant Savage. The proxy solicitation was authored by Armel and DeVennish. While there is no showing that DeVennish, as such, was personally aware of the falseness of the assertions contained in the proxy statement, he was aware of the materiality of the omissions. These conclusions with respect to Armel, Savage and DeVennish would be

arrived at and are arrived at by the requirement of either preponderance or clear and convincing.

(e) No one of the remaining director-defendants, i.e., Bolovan, Young, Patton and Tibbals, personally used or employed any manipulative or deceptive device, nor did any one of them make any untrue statement of a material fact, nor did any one of them omit to state a material fact. None of them personally had anything to do with the proxy statement or any part thereof. Each of them relied on the Certified Public Accountant for the accuracy of the figures contained in the statement and each of them relied on counsel for the inclusion of all appropriate proxy material. No one of them had any expertise in matters of corporate accounting, let alone matters of intra-corporate accounting. None of them had any expertise in respect of the materiality of omissions.

(f) Essentially it is the claim of the plaintiffs with respect to these outside directors that each of them was a controlling person within the language of 15 U.S.C. 78t. That section, as has been noted, provides that any "person who, directly or indirectly, controls any person (Armel or DeVennish) liable under any provision * * * shall be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable." Whether the outside directors were or were not directors of Mortgage is not determinative of any question in this case. The outside directors were clearly directors of Credit and, to the extent liability devolves upon a director, a Credit director, under the statute as construed, would be as responsible to shareholders of Mortgage for misstatements in the proxy solicitation as would a Mortgage director. Some courts have gone to the extent of holding that a director as such is a controlling person with respect to a corporate president or counsel, since as a member of a board he clearly could exercise legal control over the president or counsel. The simple fact of the matter as applied to the Credit operations is

that Armel was a "one-man show" who could not factually be controlled by anybody related to Credit. Even as applied to such a situation, there is respectable authority concluding that a director is a controlling person. See *Moerman* v. *Zipco*, 302 F.Supp. 439 (E.C. N.Y., 1969) affirmed 422 F.2d 871 (2d, 1970) –

> "The conclusion is inescapable that persons who act as directors are in control of the corporation."

See also *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir., 1967). This, coupled with the tendency of some courts recently to expand liability from a strict scienter situation to a "negligence" situation (Cf. majority opinion in *Texas Gulf*, 401 F.2d 833 (2d Cir. 1968)) does approach the "frightening." That problem involves some differentiation between an injunction action and a damage action and has been described in *Heit* v. *Weitzen*, 402 F.2d 909 (2d Cir. 1968) as a "thicket" and conclusively in *Lanza* v. *Drexel* (S.D. N.Y. 1970), C.C.H. S.L.S. 92-826, in this manner:

> "This is not to overlook the still clouded caldron in which the oracles continue to stew about scienter. In the present condition of all that, however, it does not yet appear that anyone should be held liable, even for injunctive relief, let alone damages, unless there is at least a showing against him of 'lack of diligence, constructive fraud or unreasonable or negligent conduct.'"

Under the facts of this case, the thicket need only be entered in respect of the defendants Patton and Bolovan, who had been on the board a substantial length of time. The most that could be said of them from the plaintiffs' point of view is that they neglected to find out. While this Court would have no hesitancy in holding that a negligent director might well become involved in an injunction proceeding along with his more executive brothers, this Court is not prepared to say that a negligent director – a la 1959 – becomes liable, simply by virtue of the fact he was a director, for damages in a 10b5 case. Conclusorily, there is

no showing that either Bolovan or Patton was a person in control.

(g) In respect of the defendant Young the thicket need not be entered. Technically, the proxy solicitation constituted an offer to exchange stock made by Credit. Whether one looks at the "controlled person" as Credit or its president and counsel, the simple fact of this case is that throughout the history of Credit, Armel, Dewey, Young and DeVennish constituted a control group for the purpose of controlling Credit and its officers, including Armel and DeVennish. Both the voting trust and the Certified Investment structure demonstrates that. The relationship of those named with Commonwealth Securities reinforces that demonstration. The controlling persons with respect to Credit, and its proxy solicitation, made by mail to the shareholders of Mortgage, included the defendants Armel, DeVennish and Young – as well as Dewey.

(h) There remains the defense based on the last portion of 15 U.S.C. 78t, providing:

> ". . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation."

Since Armel and DeVennish directly induced the act by preparing and releasing the proxy, the defense of good faith is not available to them. The defendant Young did nothing directly or indirectly to induce the proxy solicitation. In fact, he knew nothing about it before it was a fait accompli. The referenced portion of 78t has been applied rather consistently so as to eliminate from liability even persons in a control position – in accordance with the statute – whose actions overally bore the badge of innocence. Or as stated in *Lanza*, supra,

> "A discriminating judgment on claims of good faith allows the court to weed out the genuinely innocent. That is as much as may fairly be asked by men who allow themselves to be installed in corporate office with power over, and

> ostensible responsibility for, the money of many other people."

The opposite of good faith is "bad faith." Bad faith certainly implies something more than negligence. Whether a director is paid or not paid has something to do with good or bad faith. That is not to say that it releases a director from responsibility – whatever that may be under the applicable state law. As a matter of fact, the defendant Young was a "for free" director of Credit at all times of interest here. Also bearing on good faith is the experience of the individual in the responsibilities of the office. When Young became a director of Credit in the early 50's, it was his first directorship. True, he became a director of several other related companies, such as Commonwealth Securities, and of an independent company, Scioto Downs, prior to the period involved here. However, Credit was his first directorate and his first experience in a directorship was with a board operated obviously as a "one-man show." There is no question at all that he did not have the slightest idea anything was wrong with anything until some time in 1960 at the earliest. Up to then he relied fully on the Certified Public Accountants who bore a good reputation and he relied specifically on the annual published certification of those accountants; he relied strictly in law matters on DeVennish, who at all times has borne an excellent reputation and still does. He relied on Armel for financial matters and Armel, up until at least 1961, had an untarnished reputation in the financial field. Finally, and most importantly perhaps, the substantial investment of Young and his family in the Credit operation which continued through the events which gave rise to this case, speaks rather eloquently of his overall innocence. Young had the burden of showing "good faith" by a preponderance; he has sustained that burden, and it is this Court's conclusion that although he was a controlling person and although his performance as a director was negligent, his actions or non-actions were in good faith. As to him the complaint should be dismissed, as it should be with respect to the defendants Tibbals, Patton and Bolovan. As to

the defendants Armel, DeVennish and Savage, this Court concludes that liability as asserted in the complaint has been established.

The above satisfied the requirements of F.R.C.P. 52. Any party may submit requests for additional or amended findings within 30 days from the date of entry hereof, and after such time (and disposition of such requests, if such be made) a consistent judgment will be entered.

This is not a judgment. Counsel are requested, at the appropriate time, to prepare and present a judgment entry —

(a) dismissing the complaint at plaintiffs' costs as to defendants Tibbals, Patton, Young and Bolovan;

(b) finding the defendants Armel, Savage and DeVennish liable for such damage as may be established on further hearing of this case.

As to this (b) and in order to prevent piecemeal appeals of this case, the proposed judgment entry may and should contain (1) a certificate as set forth in 28 U.S.C. 129b, and (2) the direction contained in F.R.C.P. 54(b), i.e., that the Court determines there is no just reason for delay in entering final judgments as aforesaid and such is expressly directed.

/s/ Timothy S. Hogan

United States District Judge

No. 71-1549

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

JOHN A. MADER, ET AL.,
Plaintiffs-Appellants,

v.

DANIEL E. ARMEL, ET AL.,
Defendants-Appellees.

APPEAL *from the* United States District Court for the Southern District of Ohio, Columbus Division.

Decided and Filed June 15, 1972.

Before PHILLIPS, Chief Judge, KENT, Circuit Judge, and MCALLISTER, Senior Circuit Judge.

PHILLIPS, Chief Judge. This is a class action for damages based upon alleged violation of anti-fraud provisions of the Securities and Exchange Act of 1934, 15 U.S.C. § 78a et seq. Jurisdiction is based upon 15 U.S.C. § 78aa.

The plaintiffs were shareholders in an Ohio corporation named Certified Mortgage Corporation, which merged in 1959 into another Ohio corporation named Certified Credit Corporation. The general background of the case is set forth in the opinion of this court in *Mader* v. *Armel*, 402 F.2d 158 and will not be repeated here. This court held that the merger of the two corporations involved a sale of securities within the meaning of the Securities and Exchange Act, 15 U.S.C. § 78j, and Rule 10b-5 adopted by the Securities and Exchange Commission. The case was remanded for trial.

On remand the case was tried only on the issue of liability. Determination of the amount of damages was

deferred. Trial of the liability issue resulted in a holding that defendants Armel, Savage and DeVennish are liable for such damages as may be established on further hearing of the case. The action was dismissed as to four defendants, including Todd Tibbals and Robert E. S. Young. Plaintiffs appeal under 28 U.S.C. § 1292(b) from the action of the District Court in dismissing Tibbals and Young as parties defendant. The District Court certified that its order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of the litigation. The District Court also directed the entry of final judgment on the issue of liability, making an express determination that there is no just reason for delay. Rule 54(b), Fed. R. Civ. P.

District Judge Timothy S. Hogan rendered a comprehensive opinion containing findings of fact and conclusions of law. The only issue now before this court is whether the District Court committed reversible error in dismissing Tibbals and Young, both of whom were directors of Certified Credit Corporation, as parties defendant.

Plaintiffs assert that both Tibbals and Young are liable under 15 U.S.C. § 78t:

> **"§ 78t. Liabilities of controlling persons**
>
> "(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> "(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions

of this chapter or any rule or regulation thereunder through or by means of any other person."

Upon the basis of the evidence, Judge Hogan found that Tibbals was not a "controlling person," and that Young was a "controlling person" but acted in good faith and did not directly or indirectly induce the acts constituting the cause of action.

The District Court found that the solicitation involved in this case constituted "a manipulative or deceptive device and contained untrue statements of material facts." It was further held that the dominant force behind Certified Credit Corporation was defendant, Daniel Armel, who functioned as President and Chairman of the Board; and that as chief executive officer Armel was able to exercise control of the Board of Directors and the executive committee, as well as other corporate officers. The court further found that both Tibbals and Young had implicit confidence in Armel and that neither of them had any reason to doubt their confidence in him until after the events which are determinative in this case.

An architect by profession, Tibbals first became associated with Certified Credit Corporation in 1959. The District Court found that he never attended or had any occasion to attend any directors' meeting of the corporation or its affiliates until November 16, 1959, just twelve days before the fraudulent proxy solicitation was mailed. In holding that Tibbals was not a "controlling person" within the meaning of the statute, Judge Hogan found that:

> "There is no evidence in this case—looking at it most favorably for inference purposes on behalf of the plaintiffs—that would justify any conclusion that Tibbals either knew there was anything wrong or should have known that there was anything wrong, or in any way, factually or legally, controlled anyone who knew that or was in combination for any purpose with any-

one who knew or should have known that anything was wrong."

The following findings of fact were made by Judge Hogan with respect to Young:

"The defendant Young first became connected with Credit in the early 1950's and very shortly after its business commenced. Young was then in his early 40's. He was an undergraduate of Ohio State University and received his Doctor of Medicine from Harvard. He was, and still is, a very busy and very successful general surgeon and, in addition to the demands of his professional practice, he has taught surgery at Ohio State University Medical School and supervised the operation of some family firms in Union County, Ohio. He has had no education in or experience with accounting matters or corporate financial matters. He had never been a director in what might be called an ordinary commercial company until he became a director of Credit. He and Armel had some passing acquaintance in school as youngsters. Armel also was a graduate of Ohio State, had achieved some prominence in the school editorial field while there, had spent some 15 or 16 years in the South and Southwest and returned to Columbus at about the time Credit was started. Armel, based on the early acquaintance, solicited Young's interest in Credit and it does appear from this record that Young and his family constituted the largest overall investor in Credit. In one fashion or another Young and what might be termed the more or less immediate members of his family invested overally in all of the related enterprises and in all the various types of capital issues some one-half million dollars plus. About one-fifth of this was in common stock of one type or another and the other four-fifths was in preferred stock and thrift certificates. The bulk of these investments were made prior to 1957 and the annual amounts were less thereafter. The change in tempo was related to the termination of a professional contract involving North American Aviation. Nonetheless, substantial investments were made in 1958 and

1959 by Young and his family and certainly there was no reduction in investments or withdrawal in either of those years. For some years prior to December, 1959, Young was not only a director of Credit, but also the chairman of its Executive Committee. The office was more a paper one than anything else. There is no indication in this record that the Executive Committee interfered in any way with the de facto control of Armel."

The District Judge ruled that, since Young was a "controlling person" within the meanings of the Act, he had the burden of showing good faith by a preponderance of the evidence, and that he had sustained this burden; that Young served as a director without compensation; that he did nothing directly or indirectly to induce the fraudulent proxy solicitation; that "he did not have the slightest idea anything was wrong until sometime in 1960 at the earliest;" and that "he relied fully on the Certified Public Accountants who bore a good reputation" and upon the annual published certifications of these accountants. The District Court held that the substantial investment of Young and his family continued throughout the events which gave rise to this case and this fact "speaks rather eloquently of his overall innocence." The court concluded that although Young was a "controlling person" and although his performance as a director was negligent, his actions or non-actions were in good faith.

We conclude that an issue of fact is presented as to whether Tibbals was a "controlling person" and whether Young acted in good faith and did not "directly or indirectly induce the act or acts constituting the violation or cause of action." See *Demarco* v. *Edens*, 390 F.2d 836 (2d Cir. 1968); *Klapmeier* v. *Telecheck*, 315 F.Supp. 1360 (D. Minn. 1970).

We hold that the findings of fact of the District Court are not "clearly erroneous." Rule 52(a) Fed. R. Civ. P.

It is further contended that the District Court committed reversible error in refusing to admit post-merger evidence. We find no abuse of discretion of the District Judge in refusing to hear testimony as to events that occurred after the merger under the facts and circumstances of this case.

Affirmed.

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IN THE

Supreme Court Of The United States

October Term, 1972

No. 72-437

JOHN A. MADER, et al.,

Petitioners.

v.

DANIEL E. ARMEL, et al.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

It is the position of respondent Todd Tibbals that the petition for writ of certiorari should be denied for the reason that the case is not one of general importance and presents no questions as to which there is a conflict of decisions between Courts of Appeals, and for the further reason that the issues presented were correctly decided by the District Court and the Court of Appeals.

QUESTIONS PRESENTED

1. Was respondent Todd Tibbals "a controlling person" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934, under the circumstances of this case.

2. Did respondents act "in good faith" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934, under the circumstances of this case.

COUNTER-STATEMENT

Certified Credit Corporation (Credit) was the principal corporation in a corporate group which included Certified Mortgage Corporation (Mortgage). Mortgage was merged into Credit on December 31, 1959, under a plan and agreement of merger adopted by the boards of directors of the two corporations on November 16, 1959, and approved by the shareholders of the corporations at special meetings on December 10, 1959. The proxy solicitation material and proxy statement mailed to shareholders before the special meetings on December 10, 1959, were prepared jointly by Daniel Armel, a director and president of both corporations, and the dominant figure in the corporate group, and Joseph DeVennish, counsel for both corporations.

The District Court found the proxy statement to contain material misstatements and omissions in violation of Section 10 (b) of the Securities Exchange Act of 1934.

Respondent Tibbals is and was at the time an architect. He owned no stock in either corporation. He was elected a director of Credit at the annual shareholders meeting in June 1959, and attended the November 16, 1959 meeting of the board of directors — the first meeting following his election — and voted for the merger. He had no knowledge that the proxy statement contained misstatements and omissions.

The District Court found that Tibbals was not "a controlling person" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934 and dismissed the

action as to him. The Court of Appeals affirmed the decision.

REASONS FOR DENIAL OF WRIT

1. Contrary to petitioners' representations, the decision (as to the liability of respondent Tibbals) which they seek to have reviewed does not rest upon an erroneous interpretation of Section 20 (a) of the Securities Exchange Act of 1934, and it is not in conflict with *McKy* v. *Hochfelder*, CCH, ¶93,601 (7th Cir. 1972), discussed below. It is principally a determination from the facts that Tibbals, a newly elected outside director, did not "control" the persons — inside directors and officers — found to have violated Section 10 (b) of the Securities Exchange Act of 1934.

The issue was decided by the trial court, and affirmed by the Court of Appeals, within the rule of the lower court cases that "control" within the meaning of Section 20 (a) is a question of fact. *Stadia Oil & Uranium Company* v. *Wheelis*, 251 F. 2d 269 (10th Cir. 1957); *Smith* v. *Bear*, 237 F. 2d 79 (2nd Cir. 1956); *Klapmeier* v. *Telecheck International, Inc.*, 315 F. Supp. 1360 (5th Div. Minn. 1970); *Jackman* v. *Erwin*, 186 F. Supp. 681 (S. D. Tex. 1959); *In re Battery Securities Corporation*, 38 Sec. & Ex. Com. Dec. & Rep. 8991 (1957).

In *Stadia Oil & Uranium Company* v. *Wheelis*, the court held, on this point:

> "Defendant Rankin contends that he is not liable to the plaintiffs because he did not participate in the stock sale to them. Plaintiffs concede that Rankin's liability arises only by reason of the so-called 'control' provisions of the Act 77o. The statute does not define the terms 'controls', 'controlled', or 'controlling'. These terms should be given a broad definition to permit the applicable provisions of the Act to

become effective whenever the fact of control actually exists. ***On the issue here presented the evidence was sharply conflicting. Rankin was one of the organizers of the company, its vice-president, and one of its three directors. His connection with the stock sales is shown by evidence that he presided over, and participated in, board meetings where the sale and disposition of the company stock was discussed and authorized. As vice-president he signed two of the Smith certificates. He was the one officer of the company who had had business dealings with Morrison prior to 1955. While he flatly denied any knowledge of, or participation in, the stock sales here under consideration, the evidence is such that the jury could reasonably infer that he 'controlled the corporation' and had knowledge of the stock sales in question. The jury resolved this factual issue against Rankin. Under the circumstances, the verdict of the jury must stand."

(215 F. 2d 275)

The rule is treated in Vol. II Loss, Securities Regulation, 2nd Ed., page 781:

"The question has been much mooted whether a person's status as an officer or director in itself makes him a controlling person for purposes, for example, of registration under the Securities Act or disclosure by a broker-dealer of a control relationship with the issuer under the Commission's Exchange Act fraud rules. The Investment Company Act, as we have seen, specifically negatives control when the 'power to exercise a controlling influence *** is solely the result of an official position'. But even there the Commission held that an individual was a controlling person when his being president was the *result* rather than the *source* of his power; in that case the president owned less than 3 percent of the company's voting stock, but he had the confidence of four family groups which together accounted for over 31 percent. Accordingly, although

a persons being an officer or director does not create any *presumption* of control, it is a sort of red light. It may take only one or two questions to bring out that a particular officer has no substantial influence or that a particular director represents a minority interest (perhaps as the result of cumulative voting) which is out of sympathy with the controlling block. On the other hand, the answer to the first few questions may demonstrate the need for a fairly extensive inquiry into the overall relationship of the particular officer or director to the rest of the managing group."

Applying this rule to the special circumstances of this case, the District Court found, and the Court of Appeals concurred, that Tibbals did not control the corporate insiders who violated Section 10 (b) of the Exchange Act. And, contrary to petitioners' bald assertion, there is nothing in this decision which puts it in conflict with *McKy* v. *Hochfelder*, CCH, ¶93,601 (7th Cir. 1972).

McKy was an action under Section 20 (a)[1] for recovery against a brokerage firm as a result of the Section 10 (b) violations of its president. The appellate court held that the brokerage firm was liable by force of Section 20 (a) jointly and severally with its president under an agency relationship theory. The same theory will not support "control" here, however, because the action is not against the corporation (the principal) but against Tibbals, and the others, individually. And unlike the relationship between a corporation and its officers, there is no agency relationship between codirectors or corepresentatives. This latter principle is expressed in Annot., 65 ALR2d 1019, 1027 (1959), as follows:

"***But it is clear that the mere status of corepresentation does not make each corepresentative

1. The related questions in *McKy* do not bear upon the questions presented by this petition.

> liable for any misconduct by a cofiduciary — something more must be shown. This principle has been expressly applied, stated, or supported by clear implication in a large number of cases".

The same principle is stated in Annot., 25 ALR3rd 941, 1046 (1969) with regard to codirectors:

> "It is a general rule that directors are not liable for the wrongful acts of their codirectors if they do not connive at them, and it is an accepted business practice to give individual directors specific duties of supervision to perform as members of the board."

Had Congress intended a different rule with the enactment of Section 20 (a), it is likely that a provision similar to the following provision in Section 11 (a) of the Securities Act of 1933 (15 USCA §77k) would have been added:

> "(2) every person [shall be liable on account of a false registration statement] who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted."

It follows that whatever the disposition of the petition for writ of certiorari in *McKy* v. *Hochfelder*, the case cannot be authority for peitioners' position here.

In summary, the issue of control under Section 20 (a) of the Exchange Act is one of fact, and the determination of this issue by the lower courts in this case can have only local impact. Certainly, there is no general importance to this case, because of this issue, which warrants exercise of this Court's jurisdiction within the rule of previous cases that writs of certiorari will be granted sparingly. See *General Talking Pictures Corp.* v. *Western Electric Co.*, 304 U. S. 175 (1938); *Forsyth* v. *Hammond*, 166 U. S. 506 (1897); *In re Lau Ow Bew*, 141 U. S. 583 (1891).

2. Both questions 2 and 3, as presented by petitioners, relate to the issue of the availability to respondents, under the special circumstances of this case, of the defense of "good faith" under Section 20 (a). This issue was not reached as to Tibbals because he was found not to be a "controlling person" under Section 20 (a). However, like question 1, questions 2 and 3, considered either singly or together, present factual issues which, from their very nature, ought not be the basis for invoking the jurisdiction of this Court.

CONCLUSION

The decision of the Court of Appeals is narrowly tied to the special facts of this case and there is no showing of conflicting decisions in other circuits. For these reasons the petition for writ of certiorari should be denied.

Respectfully submitted,

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Counsel for Respondent
TODD TIBBALS

APPENDIX

Section 10 (b) Securities Exchange Act of 1934 (15 U.S.C.A. §78 j (b).

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

*** *** *** *** ***

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 20 (a) Securities Exchange Act of 1934 (15 U.S.C.A. §78t (a).

(a) Every person, who, directly or indirectly controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-437

JOHN A. MADER, ET AL.,

Petitioners.

v.

DANIEL E. ARMEL, ET AL.,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF FOR RESPONDENT YOUNG IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court for the Southern District of Ohio (Ap. A-7) is not yet reported and the opinion of the Court of Appeals for the Sixth Circuit (Ap. A-2) is reported at 461 F.2d 1123. Prior litigation in this case as to other issues not raised here is reported at 402 F.2d 158 (Sixth Cir. 1968).

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered on June 15, 1972 (Ap. A-2), and a petition for certiorari was filed on September 14, 1972. The jurisdiction of this Court is invoked under 15 U.S.C. Section 1254 (1).

QUESTIONS PRESENTED

1. Is a director who votes for a resolution to approve a proposed corporate merger and to submit the proposal to the stockholders for their adoption "a controlling person" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934?

2. Does a director who votes for a merger which is subsequently accomplished by a proxy statement which violates Section 10 (b), and who made no effort to ascertain the details of the transaction (Ap. A-30-34), directly or indirectly induce the acts constituting the violation so that a good faith defense is not available to a 10 (b) cause of action?

3. Can a director establish good faith by proof of reliance upon advice of reputable accountants and counsel (Ap. A-38) in discharging the responsibilities of a director?

STATUTES, FEDERAL RULES AND REGULATIONS INVOLVED

The federal statute pertinent to this petition is Section 20 (a) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78t).

Section 78t. Liabilities of controlling persons

> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provi-

sions of this chapter or any rule or regulation thereunder through or by means of any other person.

STATEMENT

This action is based upon the damage to Certified Mortgage Corporation (Mortgage) shareholders from its merger into Certified Credit Corporation (Credit). As required by Ohio law, the merger was approved by both boards of directors and adopted by both groups of stockholders. The Mortgage stockholders adopted the merger in response to a joint Credit-Mortgage proxy statement which the District Court found to contain material misstatements and omission. (Ap. A-27)

Credit and Mortgage had officers and directors in common, and Credit was in control of Mortgage. The fraudulent proxy statement was prepared and mailed under the direction of certain common officers and directors. The District Court found them liable.

None of the Respondents (Young, Patton, Bolovan, Tibbals) participated in the preparation of the Proxy Statement, and none of them saw it before the Proxy Statement was mailed. However, each of the Respondents received a copy of the Proxy Statement through the mail when it was sent to the shareholders.

The merger agreement, which was included with the Proxy Statement, contained the usual language that the "merger may be abandoned by the directors of either of the constituent corporations."

Young and Patton were long-term directors of Credit. Bolovan was a paid vice-president as well as a director. Tibbals joined the Board in June, 1959. The first meeting he attended was the one at which the merger proposal was approved.

Young, Chairman of the Executive Committee, was found to be a controlling person. However, he (as well

as the other respondents) was held to have established the defense of good faith. (Ap. A-30, 37-39)

Respondents were not held liable under Section 20 (a). On appeal the Sixth Circuit Court affirmed.

ARGUMENT

The decision of the Sixth Circuit Court of Appeals and the District Court are clearly correct and in accord with judicial precedent in cases with similar facts and circumstances. This case presents no issue of fact or law which this Court should review.

The decisions below are not in conflict with the decision of the Third Circuit in McKy v. Hochfelder, Seventh Circuit No. 71-1272, April 12, 1972 (before this Court on petition for certiorari, Dkt. No. 72-235) or any other circuit court of appeals, but on the contrary the circuits are, if one carefully analyzes the facts involved, in accord on the issues raised by this case.

The decision below is in clear accord with both the legislative and administrative history of the law and rule involved and presents therefore no important questions of federal law.

No argument is made in this brief in response to Question 1, as Respondent, Robert E. S. Young was found to be a "controlling person" within the meaning of Section 20 (a) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78t). Arguments in opposition to this Petition on this question will be presented by counsel for Respondent, Todd Tibbals.

Petitioners are urging this Court to accept the unique theory that Sec. 10 (b) and its Rule 10 b-5 (17 C.F.R.

§240.10b5) impose upon a director of a corporation involved in a merger under the circumstance of this case a duty to (1) ascertain the "true" financial condition of his corporation and any corporation with which it has a merger connection; (2) examine any proxy solicitation material and determine who are the directors of the corporations *inter alia;* (3) examine the portfolios of each corporation involved and determine the true value of each asset (tangible and intangible) of any corporation in which the merging corporations had an interest; (4) determine the scope of business actually conducted by the corporation involved; (5) examine the books of account and all financial statements of any corporation involved directly or indirectly (Ap. A 22-25, A 10-15) (6) and, in the light of the true facts determined above, judge whether the exclusion of any one would be "a material omission" under Section 10 (b); (7) and, *most importantly,* Petitioners are urging that directors could not rely upon the advice and counsel of attorneys at law or accountants — the only professions likely to possess the knowledge and skill necessary to make those judgments.

The inference which the Petitioners wish to foster by their statement on page 9, that had a director made a thorough analysis of the situation the merger would not have taken place and on page 10, that the directors were confronted with a situation which called for an examination and questioning of inside directors, is that there was some evidence that a misleading proxy statement was being used and which evidence the Respondent-directors "ostrich-like" ignored. There was not one bit of such evidence offered at the trial of this case. The trial judge commented, during oral argument after 3 days of trial concerning that point as follows:

THE COURT: You can certainly say this much, that a sophisticated organization like the Ohio Securities people and a sophisticated organization like Squire, Sanders, who at least evidently took some sort of look at something connected with this, and a sophisticated organization like the Securities and Exchange Commission, there being some affirmative evidence on this record that there was some talk about this company with the Securities and Exchange Commission before all this happened—those sophisticated organizations didn't think there was anything wrong with the statement. That's certainly true.

You know, what makes some of the things difficult is that this was not a statement that an ordinary person would sit down and say, "O.K., there is something wrong with it," we don't think. Otherwise, it wouldn't take an SEC expert like Guthrie a week in testimony to come to a conclusion, and it took him a week to lay the background for the conclusion, and it took him two years of looking before he got to be able to testify a week. So we go along with you on that.

Go ahead. I didn't mean to interrupt. (Tr. 959)

Petitioner argues that certiorari must be granted because the decision of the Sixth Circuit is in direct conflict with the holding of the Seventh Circuit in *McKy v. Hochfelder,* supra. The decision of the Court of Appeals in *McKy* is based upon four (4) independent and alternative grounds any one of which adequately supported the decision reached by that court. The one alternative ground of that decision involved in this case is that the court found the Defendant - First Securities Company did not act in good faith as a "controlling person." *McKy* was the court appointed receiver of the property and assets of First Securities Company of Chicago. First Securities Company of Chicago was a broker-dealer who

by the enforcement of a rule established by the perpetrator of the fraud thereby directly facilitated the prolonging of the fraud. It was this affirmative act of participation which led the court to conclude that First Securities failed to act in good faith.

There is no conflict between the *McKy* decision and the decision of the Sixth Circuit in this case. The *facts* in the *McKy* case supported the finding that the defendants had not established their defense of "good faith" whereas the *facts* in the instant case supported the findings that the defendants had established their defense of "good faith".

The case of *Myzell v. Fields*, 386 F.2d 718, 738, 739 (8th Cir. 1967), cert. den, 390 U.S. 95 (1968) cited by Petitioner on page 7, involved a *controlling person who was the intended beneficiary of the alleged violation of the act.* The court said "Under such circumstances, if the direct purchaser fails to disclose material information in violation of Rule 10b-5, the "controlling person" [intended beneficiary] cannot excuse himself, even under the "good faith" clause of Section 20 (a)." There was absolutely no evidence offered at the trial of the instance case from which any analogy could be made to the *Myzell* case.

Hecht v. Harris, Upham & Co., 283 F.Supp. 417 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970), cited by Petitioner on page 7 involved a broker-dealer. The court concluded at page 433 that "churning" (essentially involving a bad faith, fraudulent purpose of the broker to derive profit for himself) is a violation of Sec. 10 (b). In fixing liability upon the defendant brokerage firm for the acts of its representative, the court at pages 438 and 439 noted the good standard practice in the brokerage business and found from the

evidence that the defendant brokerage firm's actions did not measure up to those standards and therefore could not be said to have acted in "good faith" within the meaning of Section 20 (a).

In the instant case absolutely no evidence was offered to show that the actions and non-actions of Respondent Young was not in accord with the standard practice.

Lorenz v. Watson, 258 F.Supp. 724, 732, 733 (E.D.Pa. 1966) cited by Petitioners on page 7 involved a broker-dealer and was decided on a motion to dismiss. The question of good faith defense under Sec. 20, being a question of fact to be determined at the trial, was not reached. The opinion of the court as stated by the Petitioner is dicta.

Petitioners are asking this Court to hold an innocent person civilly responsible under Sec. 10b without any evidence to connect the wrong doing to the person against whom redress is sought.

It is submitted that more than *de jure* power to control is required under Section 20 and that the *McKy* case is not in conflict even on legal theory basis. More is involved than a *de jure* power when broker-dealer firms entrust their employees with authority to deal with the public for the profit of the firm.

Moreover, it is the position of the Securities and Exchange Commission that Section 20 has no application to a broker-dealer's liability for frauds of its employees. (See Brief of the Securities Commission (pages 10-17 filed in *Kamen & Co. v. Paul H. Aschkar & Co.*, 393 U.S. 901)

Petitioners quote on page 6 of their petition from Section 1721.59(A) of the Ohio Revised Code to the effect that all authority of a corporation shall be exercised by its directors. The Respondents below *did not*

base their defense on their negligence as the Petitioners state on page 10 of their Petition. The Respondents defense was predicated upon their good faith in their acts and that this defense was recognized under the Ohio law as well as federal laws. This Court said in *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 465 (1969) that Section 10b actions constitute an "area where glib generalities and unthinking abstractions are major occupational hazards." To equate the broker-dealer relationship to a corporation-director relationship is a glib generality which ignores the law of corporations and practical reality.

At the time this action accrued, the case law of Ohio recognized that directors were not required or presumed to be acquainted with all the corporation's affairs or its transactions, and that directors had a right in forming their conclusions to rely upon information furnished and conclusions expressed by management. *Goff v. Emde*, 32 Ohio App. 216 (1928), *Jensen v. Republic Steel Corp.*, 32 Ohio Law Abs. 20, (1937). The case law has since been codified in Section 1701.59 (B) of the Ohio Revised Code which provides:

"...

"(B) In discharging his duties, a director may, when acting in good faith, rely upon the books and records of the corporation, upon reports made to the corporation by an officer or employee or by any other person selected for the purpose with reasonable care by the corporation, and upon financial statements or written reports prepared by an officer or employee of the corporation in charge of its accounts or certified by a public accountant."

Petitioner in his Question 2 argues that when a director votes for a merger which is subsequently accom-

plished by the use of a proxy statement he thereby induces a *false* and *fraudulent* proxy statement, and may not avail himself of the "good faith" defense in Section 20 (a). Petitioner would not permit a jury or court to look to the facts surrounding the actions, position or capabilities of a defendant director.

The contention of Petitioners here ignores the plain meaning of the law as well as the congressional intent as found in legislative and administrative histories. In *Kahn v. American Metal Climax, et al,* 458 F.2d 255, a case decided on March 31, 1972 by the 3rd Circuit and now before this Court on cross-petitions for certiorari (Dkts. 72-5 and 72-132), Judge Adams in his concurring and dissenting opinion, after a thorough analysis of the official documentation of congressional and administrative intent concludes that neither the statute nor the rule even imply that liability is imposed without culpability (Pg. 277); that the statute and rule were designed as a safeguard against fraud or other culpable conduct and not as a general regulation of business affairs. (Pg. 278)

The position of the Commission, stated on page 16 of its Brief in *Aschkar v. Kamen,* cited supra, is as follows:

> "The controlling-persons provisions of the securities acts, on the other hand do *not* impose responsibility even when actual or apparent authority is present, if the controlling person is personally innocent. The allowance of this defense in the controlling-persons sections is consistent with the congressional purpose of tempering its *extension* of vicarious liability by allowing such a person to demonstrate his personal freedom from fault."

The conclusion of the Petitioners that the Respondent-Directors are liable, requires this court to adopt the following unprecedent theory:

If a director votes for a merger involving the use of proxies —

(1) the court should infer that such director is a "controlling person";

(2) from that inference the court should further infer that such director induced, directly or indirectly, the proxy statement;

(3) and from that inference the court should still further infer that such director induced, directly or indirectly, the act of violation, that is, the false and misleading statements or omissions in the proxy statement.

Judge Adams of the Third Circuit has made an exhaustive study of the elements of culpability in 10b 5 and related cases. In his concurring and dissenting opinion in *Kahn v. American Metal Climax, et al.,* (cited *supra*), he concluded:

> Close examination of the cases discussing fraud reveals that the courts which on the surface appear to have drifted away from the intent of Congress, as explicitly expressed in the legislative and administrative history of the Act and Regulations, have not demonstrated sufficient justification for their language. Scrutiny of the facts in the cases demonstrates that the culpability contemplated in the Act was indeed present, frequently in flagrant form.
>
> (Pg. 286)
>
> * * * * * *
>
> The first factor which becomes apparent is that in every case where liability was found, conduct tantamount to actual fraud existed, despite the fact that the reviewing court may have used language broader than necessary. In no case was liability affixed to non-culpable conduct, regardless of the dicta.
>
> (Pg. 286)

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be denied.

Respectfully submitted,

Robert H. Hoffman

ROBERT H. HOFFMAN

Katheleen K. Haase

KATHELEEN K. HAASE

Counsel for Respondent

ROBERT E. S. YOUNG

Date: Oct 13, 1972

APPENDIX

APPENDIX

28 USC §1254. Court of appeals; certiorari; appeal; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

(2) By appeal by a party relying on a State statute held by a court of appeals to be invalid as repugnant to the Constitution, treaties or laws of the United States, but such appeal shall preclude review by writ of certiorari at the instance of such appellant, and the review on appeal shall be restricted to the Federal questions presented;

(3) By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instruction are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy. June 25, 1948, c. 646, 62 Stat. 928.

No. 71-1549

United States Court of Appeals

FOR THE SIXTH CIRCUIT

JOHN A. MADER, et. al.,
Plaintiffs-Appellants,

v.

DANIEL E. ARMEL, et. al.,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of Ohio, Columbus Division

Decided and Filed June 15, 1972

Before PHILLIPS, Chief Judge, KENT, Circuit Judge, and MCALLISTER, Senior Circuit Judge.

PHILLIPS, Chief Judge. This is a class action for damages based upon alleged violation of anti-fraud provisions of the Securities and Exchange Act of 1934, 15 U.S.C. §78a et seq. Jurisdiction is based upon 15 U.S.C. §78aa.

The plaintiffs were shareholders in an Ohio corporation named Certified Mortgage Corporation, which merged in 1959 into another Ohio corporation named Certified Credit Corporation. The general background of the case is set forth in the opinion of this court in *Mader v. Arnel*, 402 F.2d 158 and will not be repeated here. This court held that the merger of the two comporations involved a sale of securities within the meaning of the Securities and Exchange Act, 15 U.S.C. §78j, and Rule 10b-5 adopted by the Securties and Exchange Commission. The case was remanded for trial.

On remand the case was tried only on the issue of liability. Determination of the amount of damages was deferred. Trial of the liability issue resulted in a holding that defendants Armel, Savage and DeVennish are liable for such damages as may be estimated on further hearing of the case. The action was dismissed as to four defendants, including Todd Tibbals and Robert E. S. Young. Plaintiffs appeal under 28 U.S.C. §1292(b) from the action of the District Court in dismissing Tibbals and Young as parties defendant. The District Court certified that its order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal may materially advance the ultimate termination of the litigation. The District Court also directed the entry of final judgment on the issue of liability, making an express determination that there is no just reason for delay. Rule 54(b), Fed. R. Civ. P.

District Judge Timothy S. Hogan rendered a comprehensive opinion containing findings of fact and conclusions of law. The only issue now before this court is whether the District Court committed reversible error in dismissing Tibbals and Young, both of whom were directors of Certified Credit Corporation, as parties defendant.

Plaintiffs assert that both Tibbals and Young are liable under 15 U.S.C. §78t:

> **"§78t. Liabilities of controlling persons**
>
> "(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly

or indirectly induce the act or acts constituting the violation or cause of action.

"(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule or regulation thereunder through or by means of any other person."

Upon the basis of the evidence, Judge Hogan found that Tibbals was not a "controlling person," and that Young was a "controlling person" but acted in good faith and did not directly or indirectly induce the acts constituting the cause of action.

The District Court found that the solicitation involved in this case constituted "a manipulative or deceptive device and contained untrue statements of material facts." It was further held that the dominant force behind Certified Credit Corporation was defendant, Daniel Armel, who functioned as President and Chairman of the Board; and that as chief executive officer Armel was able to exercise control of the Board of Directors and the executive committee, as well as other corporate officers. The court further found that both Tibbals and Young had implicit confidence in Armel and that neither of them had any reason to doubt their confidence in him until after the events which are determinative in this case.

An architect by profession, Tibbals first became associated with Certified Credit Corporation in 1959. The District Court found that he never attended or had any occasion to attend any directors' meeting of the corporation or its affiliates until November 16, 1959, just twelve days before the fraudulent proxy solicitation was mailed. In holding that Tibbals was not a "controlling person" within the meaning of the statute, Judge Hogan found that:

"There is no evidence in this case — looking at it most favorably for inference purposes on behalf of the plaintiffs — that would justify any conclusion that Tibbals either knew there was anything wrong or should have known that there was anything wrong, or in any way, factually or legally, controlled anyone who knew that or was in combination for any purpose with anyone who knew or should have known that anything was wrong."

The following findings of fact were made by Judge Hogan with respect to Young:

"The defendant Young first became connected with Credit in the early 1950's and very shortly after its business commenced. Young was then in his early 40's. He was an undergraduate of Ohio State University and received his Doctor of Medicine from Harvard. He was, and still is, a very busy and very successful general surgeon and, in addition to the demands of his professional practice, he has taught surgery at Ohio State University Medical School and supervised the operation of some family firms in Union County, Ohio. He has had no education in or experience with accounting matters or corporate financial matters. He had never been a director in what might be called an ordinary commercial company until he became a director of Credit. He and Armel had some passing acquaintance in school as youngsters. Armel also was a graduate of Ohio State, had achieved some prominence in the school editorial field while there, had spent some 15 or 16 years in the South and Southwest and returned to Columbus at about the time Credit was started. Armel, based on the early acquaintance, solicited Young's interest in Credit and it does appear from this record that Young and his family constituted the largest overall investor in Credit. In one fashion or another Young and what might be termed the more or less immediate members of his family invested overally in all of the related

enterprises and in all the various types of capital issues some one-half million dollars plus. About one-fifth of this was in common stock of one type or another and the other four-fifths was in preferred stock and thrift certificates. The bulk of these investments were made prior to 1957 and the annual amounts were less thereafter. The change in tempo was related to the termination of a professional contract involving North American Aviation. Nontheless, substantial investments were made in 1958 and 1959 by Young and his family and certainly there was no reduction in investments or withdrawal in either of those years. For some years prior to December, 1959, Young was not only a director of Credit, but also the chairman of its Executive Committee. The office was more a paper one than anything else. There is no indication in this record that the Executive Committee interfered in any way with the de facto control of Armel."

The District Judge ruled that, since Young was a "controlling person" within the meanings of the Act, he had the burden of showing good faith by a preponderance of the evidence, and that he had sustained this burden; that Young served as a director without compensation; that he did nothing directly or indirectly to induce the fraudulent proxy solicitation; that "he did not have the slightest idea anything was wrong until sometime in 1960 at the earliest;" and that "he relied fully on the Certified Public Accountants who bore a good reputation" and upon the annual published certifications of these accounts. The District Court held that the substantial investment of Young and his family continued throughout the events which gave rise to this case and this fact "speaks rather eloquently of his overall innocence." The court concluded that although Young was a controlling person" and although his performance as a director was

negligent, his actions or nonactions were in good faith.

We conclude that an issue of fact is presented as to whether Tibbals was a "controlling person" and whether Young acted in good faith and did not "directly or indirectly induce the act or acts constituting the violation or cause of action." *See Demarco v. Edens*, 390 F.2d 836 (2d Cir. 1968); *Klapmeier v. Telecheck*, 315 F. Supp. 1360 (D. Minn. 1970).

We hold that the findings of fact of the District Court are not "clearly erroneous." Rule 52(a) Fed. R. Civ. P.

It is further contended that the District Court committed reversible error in refusing to admit post-merger evidence. We find no abuse of discretion of the District Judge in refusing to hear testimony as to events that occurred after the merger under the facts and circumstances of this case.

Affirmed.

* * * * * *

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
COLUMBUS DIVISION

JOHN A. MADER, et al.,
Plaintiff,

v.

DANIEL A. ARMEL, et. al.,
Defendants.

MEMORANDUM OPINION

(Filed January 25, 1971)

This case is a class action and is based on 15 U.S.C. 78j, Rule 10b-5 of the Securities and Exchange Commission, adopted in pursuance thereof, and 15 U.S.C. 78t. Jurisdiction is based upon 15 U.S.C. 78aa.

The plaintiffs were shareholders in an Ohio corporation named Certified Mortgage Corporation, which merged, in 1959, with another Ohio corporation named Certified Credit Corporation (respectively referred to hereinafter as "Mortgage" and "Credit"). Credit was the resultant of the merger. The general background of this case is set forth in *Mader v. Armel*, 402 F. 2d 158, (6th Cir. 1968) and will not be repeated here.

Subsequent to that Court of Appeals decision, the appropriate action required by Civil Rule 23 (class actions) was taken. And in the course of these proceedings, at one time or another, the members of the class have been determined to be those individuals or entities which owned any type of stock in Mortgage at the time of the merger in December, 1959. As a result of that determination, evidence was limited to occurrences which took place either before that time or shortly thereafter. At the time of the merger, there were in existence stock subscriptions in Mortgage involving an amount in excess of one-half million dollars, a substantial portion of which was paid to Credit after the merger (in accordance with the terms of the Merger Agreement, attached to Plaintiff's Exhibit 3). There were communications between various of the defendants and Credit on the one hand and these subscribers on the other hand after the merger. Because of that the plaintiffs urged the relevancy of those communications. The December, 1959, boundary was adopted by this Court for two reasons:

(a) The matter seems to have been decided in the Circuit opinion under the heading of "Stock Subscriptions."

(b) When shares were purchased on subscriptions in Mortgage, the downpayment always involved enough to purchase at least one share of stock; at such time the subscriber-stockholder's

> name was entered upon the shareholders ledger of Mortgage. As a consequence, the stockholder-subscriber received communications from the company to the same extent as any other shareholder.

After the class had been determined and a substantial number of the members had 'opted out, the plaintiffs and the defendants Kent, Cowles, Nolte, Kirk and Eaton settled the questions involved in this controversy on due notice and approval.

15 U.S.C. 78j provides, insofar as relevant herein, as follows (under the title, "Manipulative and deceptive devices"):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails * * * to use or employ, in connection with the purchase or sale of any security * * * any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Pursuant to that section, the Commission has adopted and promulgated what is known as Rule 10b-5 (17 C.F.R. §240.10b-5) which provides, insofar as applicable here, as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of * * * the mails * * *
>
> (1) to employ any device, scheme or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,
>
> (3) to engage in any act, practice or course of business which operates or would operate a fraud

or deceit upon any person,
in connection with the purchase or sale of any security."

Any question of the applicability of the statutory and rule provisions to a merger and particularly to this merger has been set at rest by *Mader v. Armel*, supra. The general effect could be summarized in this fashion: The 1959 merger involved a sale by Credit to the Mortgage shareholders of Credit's stock and a purchase by Credit from the shareholders of Mortgage of their Mortgage stock.

Also very much involved in this case both affirmatively from the plaintiff's point of view and defensively from the defendant's point of view is 15 U.S.C. 78t, entitled "Liabilities of controlling persons." That section provides, insofar as pertinent here:

> "(a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule * * * thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> "(b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this chapter or any rule * * * thereunder through or by means of any other person."

Certified Credit Company was an Ohio corporation. For purposes of this case it commenced its operations in 1950. It initially engaged solely in the small loan business and that business, generally speaking, remained its backbone. It subsequently opened up a number of small loan offices in Ohio and elsewhere and, in addition,

throughout its life, it acquired, through stock issues, mergers, etc., other loan companies and credit unions. In 1957, it branched out investmentwise, as distinguished from direct operationwise, into various insurance fields, mainly through acquiring control of small insurance companies. By 1959, its direct and associated operations were carried on in Ohio, Indiana, Alabama, Massachusetts, Louisiana, Arkansas and Texas. Its "on paper" growth was somewhat phenomenal. For instance, its balance sheet in the finance company area in 1950 was less than $200,000; in 1959, it was over $9 million. Its affiliated insurance—whether one calls them investments or indirect operations—went from a zero balance sheet in 1957 to something in the neighborhood of $4 million in 1959 on paper. During its lifetime, which extended from 1950 to 1961, it raised capital funds in excess of $6 million, predominantly from stock and the sale of thrift certificates or debentures, or the sale of stock in subsidiaries. At least on paper these stock sales were intrastate in character. To further complicate matters, the so-called "investments" in insurance operations were by and large not directly in the regulated type of insurance company; or stated otherwise, were not directly related to companies which actually did insuring. These investments were in companies which were non-regulated but which, on the other hand, controlled affiliated insurance companies. At one time or another, the parent, Credit, was related or affiliated with and controlled (either via stock ownership or management contract or control stock position) some 20 or 30 other companies—Mortgage as an example, as we shall see. For our purposes, by and large, the companies other than Credit involved in these intercompany relationships had no employees as such. The management of Credit furnished itself and its Credit employees to these various related

companies, did what the management and the employees of these related companies normally would have done had they had management or employee personnel; periodically the "parent" charged these related companies for these services. Whether these charges were "out of thin air" or "related to the facts" was somewhat of a controversy in this case, which is not deemed to be important. However these charges were determined, the charges when made appeared on the books of the parent in one fashion or another as an asset—either as a receivable" or as an "investment" or as a "long-term receivable." To the extent that the charges would appear as "investments," the method was by capitalizing the charge or adding it to whatever the then cost of the particular investment might be. Through the entire life of this company and its affiliates, not one cent of these charges was ever paid to the parent by any subsidiary or affiliate (with one possible exception and that was a bookkeeping accident). The capitalization to investment was, of course, totally unwarranted. There is no real argument on this record that the charged companies were never in any position to pay, nor is there any argument that if a company involved in the "investment" addition method had liquidated nothing would have been realized in respect of any company upon that part of the charge which had been capitalized. The net effect was to render false the statements of Credit not only insofar as cash and receivables, investments and long-term receivables were concerned, but also the portions of the statements dealing with surplus and earnings. For instance, limited to the intercompany charges taken into income via the receivable method—in 1952 this amounted to approximately $60,000. In 1957 that had grown to approximately $400,000 and it went up approximately $100,000 a year thereafter during the period of interest

here. The published statements of Credit in 1958 and 1959 were, in broad conclusion, at least 40 percent false and any correct statement, by generally accepted accounting methods, would have indicated Credit in 1959 was hopelessly insolvent and losing money hand over fist.

Shortly after Credit entered the insurance field and as a result of some preliminary skirmishing with the S.E.C., it became at least impracticable for Credit to obtain any additional capital funds through the sale of its own stock. The company and its management at that time did, unquestionably, have quite a favorable reputation in the Central Ohio area. Credit was growing by leaps and bounds, based on its published statements, and the snowball continued to roll down the hill. That situation led to the incorporation of Mortgage. It also led to the incorporation of an Ohio corporation named Commonwealth Securities, Inc. (hereinafter called "Securities"). The published purpose of Mortgage was the furnishing, through it, a vehicle through which the well-known Credit company could enter into the real estate mortgage field. Mortgage, like its parent, was to have two classes of common stock, one of which, A, would be sold for approximately $10.00 a share; the other of which, B, would be sold for a few cents a share. A substantial amount of the B stock was to be acquired by Credit. The shares voted equally. This method of exercising control over a subsidiary or affiliate was well established in the Credit operation and the method included itself. In other words, Credit, too, had A and B shares outstanding—the A cost a relatively substantial amount of money and the B cost a few cents, and both voted equally. Commonwealth Securities was to be and did become the underwriter of Mortgage's stock. The underwriting fee was substantial.

Two issues and underwritings of Mortgage stock took place—one in 1958 and one in 1959—as a result of which approximately 300,000 shares of A stock were sold or subscribed for. In other words, the public investors who invested in the A stock contributed in capital funds to Mortgage approximately $3 million, less the underwriting fees. Approximately 40,000 shares of B stock were purchased by the parent, Credit, at 10 cents a share, and represented an investment of some $4,000.00. Of the capital funds realized by Mortgage, $1,700,000 was invested in thrift certificates or debentures issued by Credit —or stated otherwise, of the actual cash realized by Mortgage from the issue of its own stock during its life, less unpaid subscriptions and less underwriting fees, more than two-thirds found its way into the capital (debentures) of Credit. With one exception involving a $300,000 loan to a company known as Columbus Trotting Association and subsequently as Scioto Downs (a trotting track), which was a somewhat related operation, and with one other possible exception, Mortgage never did any mortgage business at all—its sole business was raising capital for Credit.

Before describing the merger and the proxy solicitation which furnishes the basis for this case, it would be well to digress and describe the relationships of the various individual defendants with Credit and Mortgage. The founders of Credit were the defendant Daniel E. Armel, who served it as president and director through its lifetime; and Marshall B. Dewey, who served it as chairman of its board and director at least through most of its lifetime. There is not a great deal in the record in this case with respect to Dewey. There is a considerable amount in this record in respect of Armel. It could be and is summed up in the language of Chief Judge Wein-

man at the sentencing in a criminal case related to this case as follows:

> "The dominant force without any question behind the Certified Credit Corporation was Daniel Armel. * * * He functioned as President and the Chairman of the Board. Regardless of title, Armel was Certified's chief executive officer; he was able to exercise control of the Board of Directors and the Executive Committee, as well as other corporate officers."

De facto, Certified Credit was a "one-man show." All of the directors had implicit confidence in Armel and at least insofar as what might be called the outside or non-employee directors, none of them had any reason to doubt their confidence in him until after the events which are determinative in this case.

The defendant DeVennish is a lawyer admitted to the Ohio Bar about 1945. He was secretary, director and general counsel of Credit since it was founded, was a director and general counsel for Mortgage and was an officer and director of a number of the companies affiliated with Credit. Mr. DeVennish was an outside retained counsel.

The defendant Savage was the treasurer of Credit since 1955. He was a director of both Credit and Mortgage and had been associated with the Southern Ohio accounting firm of Hathaway & Hathaway prior to his association with Credit. In the criminal case to which we have referred, Savage was a defendant and pled guilty to Count 1 in the indictment in that case. Count 1 included a great many charges, one of which in essence charges exactly what the amended complaint in this case charges.

The defendant Tibbals is an architect by profession. He first became associated with Credit in 1959; he never

attended or had occasion to attend any directors' meeting of either Credit or its affiliates until November 16, 1959, just 12 days before the proxy solicitation was mailed. There is no evidence in this case—looking at it most favorably for inference purposes on behalf of the plaintiff—that would justify any conclusion that Tibbals either knew there was anything wrong or should have known that there was anything wrong, or in any way, factually or legally, controlled anyone who knew that or was in combination for any purpose with anyone who knew or should have known that anything was wrong. He was dismissed from this case on motion at the end of the plaintiffs' case and that dismissal should be formalized in any judgment entered in this case.

The defendant Patton is a manufacturer from Springfield, Ohio. He first became connected with Credit in 1953 on his election to the board. The defendant Bolovan was at all times an operations man. While he was a full-time employee of the company and was a director of Credit, as well as Mortgage, and bore the title of vice president in charge of finance—nonetheless, his real field was operations. He had nothing to do with finance as such. Like Patton, he had no knowledge of anything manipulative, nor did either of them, on the evidence in this case, have any reason to suspect any wrongdoing. Furthermore, neither of them was in any way a member of any group which could or did exercise any control excepting only that each was a member of a board, which board exercised control. One position of the plaintiffs is that the board necessarily has a right to control an officer such as Armel and that any member of that board therefore exercises "indirect" control over an officer and is responsible under 15 U.S.C. 78t. To steal a phrase from Judge Friendly (401 F. 2d 866), the consequences of such a holding "are frightening." Be that as it may,

and as to each of these defendants, Bolovan and Patton, it is found that each of them acted in good faith and, in addition, that neither of them directly or indirectly induced the falsifications or deficiencies in the proxy solicitation (15 U.S.C. 78t). The complaint as to each of them should be dismissed in any judgment entered in this case.

The defendant Young first became connected with Credit in the early 1950's and very shortly after its business commenced. Young was then in his early 40's. He was an undergraduate of Ohio State University and received his Doctor of Medicine from Harvard. He was, and still is, a very busy and very successful general surgeon and, in addition to the demands of his professional practice, he has taught surgery at Ohio State University Medical School and supervised the operation of some family firms in Union County, Ohio. He has had no education in or experience with accounting matters or corporate financial matters. He had never been a director in what might be called an ordinary commercial company until he became a director of Credit. He and Armel had some passing acquaintance in school as youngsters. Armel also was a graduate of Ohio State, had achieved some prominence in the school editorial field while there, had spent some 15 or 16 years in the South and Southwest and returned to Columbus at about the time Credit was started. Armel, based on the early acquaintance, solicited Young's interest in Credit and it does appear from this record that Young and his family constituted the largest overall investor in Credit. In one fashion or another Young and what might be termed the more or less immediate members of his family invested overally in all of the related enterprises and in all the various types of capital issues some one-half million dollars plus. About one-fifth of this was in common stock of one type or another and the other four-fifths was in preferred

stock and thrift certificates. The bulk of these investments were made prior to 1957 and the annual amounts were less thereafter. The change in tempo was related to the termination of a professional contract involving North American Aviation. Nonetheless, substantial investments were made in 1958 and 1959 by Young and his family and certainly there was no reduction in investments or withdrawal in either of those years. For some years prior to December, 1959, Young was not only a director of Credit, but also the chairman of its Executive Committee. The office was more a paper one than anything else. There is no indication in this record that the Executive Committee interfered in any way with the de facto control of Armel. As has been pointed out, control over the Credit companies was exercised through a Class A-Class B common stock setup in which Class B voted equally with A, but was a "cheap stock." The design originally was to so preserve complete voting control for Armel and Dewey. As a matter of fact, Armel and Dewey had an option to buy B shares of Credit running into the millions of shares. Outsiders and specifically members of the public were not permitted to buy the B shares separately — generally speaking, the B shares which outsiders acquired resulted from sales of A and B as a unit. As Credit grew and these unit sales increased, Armel and Dewey were unable to purchase a sufficient number of B shares to retain control of Credit.

In 1953, and in order to assure the continuance of this control, a Voting Trust Agreement was entered into involving Armel, Dewey, DeVennish and Young. Young had been permitted to acquire B shares alone, as distinguished from a unit basis. DeVennish also owned some B shares. Under the Voting Trust Agreement, Dewey and Armel retained voting control of all the B

stock of the four named. For reasons which are not clear on this record, in 1954 this Voting Trust arrangement was terminated and all of the B shares of the four persons above named, together with the option of Armel and Dewey to purchase additional B shares, was transferred to a company called Certified Investment Corporation. Each of the above named transferred to Certified Investment an amount of Class B shares of Credit proportionate, overally, to his individual ownership in Investment. The percentages were as follows:

Armel	30%	Young	30%
Dewey	30%	DeVennish	10%

There was a tacit understanding between Armel and Dewey that their 60% would be voted as a block and that each had a first refusal right to purchase the 30% of the other, which extended to the other's estate in the event of death. As a matter of fact, shortly before Dewey died in 1962, he sold his 30% to Armel. The purpose, of course, of the Certified Investment arrangement was to insure the continued control by Armel and Dewey, so that there is no doubt on this record that Young and DeVennish joined with Armel and Dewey to constitute a group which controlled the action of Credit. In fact, those four individuals did constitute a control group as that language is used in 15 U.S.C. 78t. In addition, as has been noted, Commonwealth Securities was formed in 1957 or 1958 for the purpose of "making a market" for Credit stock. It proposed to engage in, among other things, the underwriting field. Armel brought two individuals into Ohio from Texas for the purpose of operating it. There was a starting requirement for its proposed operations of a minimum $25,000.00 in capital. That capital was provided wholly by Young. Initially half of it went directly to the company as a capital contribution from Young; the other half went to Armel as a

loan and then from Armel to the company. The eventual result was the issue by the company of 25% of its stock to Young, 25% to Dewey and 25% to each of the Texans brought in to manage the company. This was the company which underwrote the sale of Mortgage's common stock to the public. (There were really two separate underwritings.) It was via this underwriting that the public purchased and the company obtained some $3 million in capital funds, less a substantial underwriting commission of approximately $300,000.

In 1959 Armel proposed to merge Mortgage and Credit. The stated reason (by Armel) was that instead of trying to develop the mortgage business through the mortgage company, it was financially advantageous to use the funds which had been raised for that purpose to buy some existing companies in the mortgage business and that these companies could better be acquired and operated as direct subsidiaries of Credit. Since Armel, based on the published performance to date, appeared to be somewhat of a financial wizard, there was no questioning of this purpose by anyone. An indication of the real reason can be seen by a look at the result. As has been noted, Mortgage had in fact invested in the neighborhood of a million and a half of its capital funds in Credit debentures. These debentures were subordinated and appeared on the Credit statements as capital funds. However, vis-a-vis stock, the subordinated debentures constituted a debtor-creditor relationship and in that sense the total debenture liability of Credit before the merger amounted to approximately $3 million. After the merger this liability appeared as only approximately $1,300,000. In effect, the result was to capitalize the million and a half; or stated otherwise, was to convert the shareholder classes of Mortgage from a million and a half creditor status vis-a-vis Credit's shareholders to a

simple co-shareholder of Credit status. As a result of the proposal to merge, a Plan and Agreement of Merger was prepared and this Plan and Agreement of Merger was transmitted to the shareholders of Mortgage and Credit by mail as a part of a proxy statement, a letter of transmittal and a proxy and notice of shareholders' meeting. The proxy statement was a joint one on behalf of both companies. The mailing date was on or about November 28, 1959. The shareholders' meeting date was December 10.

The particular terms of the agreement of merger are not of particular significance. In a nutshell, all of the assets of Mortgage were to be transferred to Credit; Credit was to assume all of the liabilities of Mortgage; the shareholders of Mortgage were to surrender their stock and receive in exchange therefor stock of Credit. At the time of the merger, in addition to the debentures, Mortgage had assets consisting of two mortgage loans amounting to approximately $365,000.00 which eventually proved good and were paid and, in addition, it had an asset titled "Unpaid Subscriptions" which amounted to some $600,000 plus, on which eventually some $400,000 plus was realized. Nor were the debentures themselves valueless at that time. After several more years of mismanagement and a bankruptcy, some small dividends were paid on the Credit debentures. While the sole oral evidence in this case of damage as the result of the merger was to the effect that the only fair way to value Mortgage stock at the time of the merger was on a liquidating basis and its liquidating value was not affected by the merger, that testimony cannot be accepted in the light of the facts above referred to. In December of 1959 there was some demonstratable liquidating value to Mortgage stock before the merger. After the merger, the Credit company, on any liquidation, would have

distributed nothing to its shareholders. (See S.E.C. Exhibit referred to in this record as 13.) Accordingly, conceding the plaintiff, in a case such as this and in a trial of the severed issue of liability, has the burden of showing some damage resulting from the merger (see *Mills v. Electric Auto Light*, ___ U.S. ___ (1970), Part 3), the plaintiff in this case has satisfied that proof requirement by a preponderance.

Two matters should be dealt with before attention is directed to the proxy solicitation directly—

First—from the time of its formation, the records of Credit (and subsequently of the other companies involved) had been kept under the general supervision of a firm of Certified Public Accountants — Hathaway & Hathaway — which firm had offices at least in Cincinnati and Columbus, Ohio. The annual statements were prepared and certified by that firm of Certified Public Accountants. In addition, monthly statements were prepared. It does not appear whether these monthly statemens were prepared by that firm. These monthly statements (referred to in this record as "blue lines") have been examined. The form of the monthly statements is generally consistent with the form of the annual statement and it is a reasonable inference that these blue lines also are attributable to that accounting firm. During the times of interest in this case, that firm was duly certified by the State of Ohio as authorized Certified Public Accountants to report on examinations and certify the results. Year by year, these reports to the board of directors of Credit were made by that firm. This accounting firm, which had a good reputation at the time and was well recognized, repetitively reported to the board of directors of Credit that at least their annual examination "was made in accordance with generally accepted auditing standards, and accordingly included such tests

of the accounting records and such auditing procedures as we consider necessary in the circumstances." The certifying letter dealt specifically with the items booked as "Investments and advances to subsidiaries" and in each case concluded, after multi-page comments and multi-page statements, with the following:

> "In our opinion, subject to the foregoing comments, the accompanying balance sheets and related statements of income and expense and surplus present fairly the financial position of Certified Credit * * * and the results of their operations for the year then ended, in conformity with generally accepted accounting principles * * *."

In the reports, certified by the accountants, the subjects of investments and advances to subsidiaries were specifically dealt with in a fashion which would lead a reader to the conclusion that the usual test for accuracy, accountwise, had been applied to these assets and satisfied by applying them in conformity with generally accepted accounting principles. There was, for instance, no statement such as this:

> "In 1952 this company advanced some $62,000.00 to two subsidiaries totally owned by it. These advances are presently shown on the company's books as a receivable in the amount of $62,000.00 Not one cent has been paid on this obligation during the seven years of its existence. Your accountants have made no effort to ascertain whether these subsidiaries have ever had or have now the ability to pay all or any part of this receivable. The collectibility has been merely assumed and that assumption results in increasing the income account of this company by $62,000.00 and that increase in reflected in the present surplus. The same is true of the other capital advances to the other companies which now (in 1959) amount to in excess of $800,000.00. In addition, there is included in this balance sheet as in-

vestments in affiliated companies and subsidiaries some $3,000,000.00. A substantial amount of that represents advances made by this company to its affiliates and subsidiaries for current operating expenses. Not one cent has ever been repaid. The advances have been capitalized by adding the amounts involved to the book value of the particular investment. No examination has been made to ascertain whether the facts warranted the capitalization."

While the outside directors (i.e., those not employed by Credit as officers) who testified in this case, each disclaimed ever having seen either the blue lines or the annual reports of the Hathaway firm, there is no question that the form of report submitted to the directors at directors' meetings, as well as the form of the published reports of the company, were based on the Hathaway statements. They were abbreviations. For example, the published statement for 1959 for Credit, insofar as a balance sheet was concerned, was a one-page affair listing as assets "Cash and Receivables" lumped together in the amount of approximately $3 million and "Investments and Long-term Receivables" also lumped together in the amount of approximately four and one-half million dollars. These figures were the resultant figures in the Hathaway report and the published figures contained in the Annual Report of the company—each contained on its face and in a prominent one-page style the Hathaway certificate in the form referred to above. In net effect, since each director conceded knowledge of the annual report, the abbreviated statements which the directors had viewed at directors' meetings of Credit were entirely consistent with the annual statement contained in the annual report, which included a certificate of "testing" and conformity with generally accepted accounting principles."

One of the claims of the plaintiffs directed to the merger proxy is that it was false and misleading in that it lumped cash and receivables together rather than breaking them down. Had they been broken down, it would have appeared that the cash actually amounted (in the 1959 figures) to some $42,000.00 and the receivables to $2,885,000.00 approximately. In net effect, this would have shown on the face of the statement that the cash on hand was less than a month's operating expense. That the method of presentation was deceptive cannot be denied objectively. However, Armel did have what appeared to be a reasonable explanation for the shortness in cash at any time it was questioned by a director—his point being that a finance company was in the business of keeping its cash at work and the smaller the amount on hand, the more that purpose was being served, and, secondly, the method of treatment had been underwritten in the accountants' published statements.

Before leaving these accountants—this record affirmatively indicates that at the Credit directors' meeting dealing with the merger, a Credit director questioned whether the exchange as proposed in the merger was not too favorable to Mortgage. That director and the other members of the board were told by Armel that the proposed exchanged would be checked into and verified by Hathaway & Hathaway on a "market basis" so that, in net effect, at the very happening of the events which gave rise to this case, the Credit directors were informed by Credit management, in addition to what appeared in the accountants' certificates, that the accountants were knowledgeable on a market or real value basis.

The second matter to be dealt with is this: Just who were members of the board of directors of Mortgage. There is no doubt that Armel, Savage, Bolovan and

Dewey were. Nor is there any doubt that DeVennish was. Four, therefore, out of the five claimed inside directors and the counsel of the company were clearly shown to have been directors of Mortgage at the times of interest here. One inside director, an insurance vice president, while claimed to have been a director according to the minutes, flatly denied that he was ever informed of his election. Every outside director of Credit, claimed by the plaintiffs to have been a director of Mortgage, who testified in this case (at least four), flatly denied ever being notified of their election as a Mortgage director. Some conceded that they had been told that they were going to be and expected to be. There was considerable newspaper publicity in the areas in which these directors lived and in connection with the stock sales of Mortgage, naming these outside individuals as directors of Mortgage and, in addition, they were described as such on the prospecti issued in connection with the two stock sales; also, one or more were connected by the evidence in this case with proxy returns for annual meetings of Credit, etc. It was clearly established in this case that the minute book of Mortgage in certain respects had absolutely no relevance to actual fact. For instance, Young is shown in the minutes to have been present at at least three directors' meetings when he was unquestionably at least 500 miles away from the meeting place. It would be a fair conclusion that the minutes of Mortgage were falsified by the same management which had no hesitancy in falsifying its accounting records. The plaintiffs have not borne the burden of establishing that any of the defendants in this case, other than Armel, Savage, DeVennish and Bolovan were directors of Mortgage. There is no doubt that all of the other defendants in this case were directors of Credit in 1959 when the proxy solicitation was mailed.

To return to the proxy solicitation—

The plaintiffs have established that the proxy solicitation material, which included the proxy statement, a transmittal letter and a notice (the one signed by Armel and the other signed by DeVennish) and a proxy were mailed to the shareholders of record of both Credit and Mortgage in November of 1959. The proof relied on was more circumstantial than direct due to the fact that a great many of the company records had been turned over to one or the other government agency and that, coupled with the erosion of time, prevented direct proof. The circumstantial evidence, however, was adequate and based thereon it is found that the proxy statement was mailed as claimed by the plaintiffs.

In determining whether the proxy statement "made any untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading," this Court is applying to the various claims of the plaintiffs the tests for materiality stated in *List v. Fashion Park*, 340 F.2d 457 (2nd Cir. 1965 as follows:

> "The basic test of materiality is whether a reasonable man would attach importance, *** in determining his choice of action in the transaction in question. This, of course, encompasses any fact *** which in reasonable and objective contemplation might affect the value of the corporation's stock or securities."

The material misstatements and omissions in the proxy solicitation material included the following:

(a) It was stated in that the boards of directors of both Credit and Mortgage deemed the merger advisable and had approved the proposed agreement; while the proxy material did

state, "The management of Credit may be considered to be in control of Mortgage," it did not disclose the fact that each member of the board of directors of Mortgage was a member of the board of Credit.

(b) The proxy material indicated that Mortgage was a "subsidiary" of Credit. It did not disclose that in excess of $1,200,000.00 of Mortgage's capital had been paid by the public and only something in the neighborhood of $4,000.00 had been paid by Credit; nor did the proxy statement disclose how many shares of Credit or Mortgage the board members of Credit and its officers owned — and without regard to who is considered to be on what board. There simply was no disclosure that the people who controlled Credit had a substantial stock interest in Credit and practically no stock interest in Mortgage. The proxy material simply lead the reader to believe that an independent board of Mortgage had considered and approved the merger. In fact, to whatever extent Mortgage had a board, members thereof had no shareholding interest in Mortgage as such, but were heavily interested in Credit.

(c) The proxy material indicated that DeVennish was counsel for Credit. It omitted to state that he was also counsel for Mortgage. Once agin, DeVennish had a substantial stock interest in Credit and, insofar as this record shows, no stock interest in Mortgage — that was not disclosed.

(d) The proxy material claimed for Credit as of the date of the proposed merger a surplus of some $586,000. With respect to that claimed surplus, it omitted any reference to whether the claimed surplus was earned or paid in, and affirmatively stated a falsehood, since in fact the company at that time, for the reasons indicated, actually had a deficit.

(e) The proxy material listed under the headings of "Cash and Receivables" and "Investments and Long-term Receivables" for Credit a total exceeding $5,000,000.00. That was false by at least 40 percent. Many of the investments and receivables had little, if any, value and that included amounts related to advances to subsidiaries above described.

(f) The proxy statement claimed that Mortgage began business in April of 1958 and indicated that its principal business had been loaning money secured by mortgages on real estate and otherwise acquiring and dealing in mortgages and other investments in real estate equities and securities. In other words, the statement was that it had been engaged in the real estate mortage business. That was false. Insofar as this record indicates, it had apparently made only two real estate loans, each to a company with which the defendant Young was connected in one capacity or another. (It should be noted that both of those were good loans and were eventually paid, at a profit to Mortgage.) Actually Mortgage's principal activity had been to "invest" in Credit's subordinated debentures. Some million and a half dollars, in excess of one-half of its capital funds, had actually been so invested at a minimum prior to the merger. The proxy statement omitted to disclose actual facts such as this: that Mortgage had principally been a conduit through which Credit had obtained additional capital funds.

Each of the statements and omissions above described was material, as above defined. There were in fact other misstatements and omissions in the proxy solicitation not considered material by this Court.

The proxy solicitation material, and specifically the statement, was prepared by Armel and DeVennish joint-

ly. No other director of either Credit or Mortgage actually saw the proxy statement prior to the time of its distribution and there is no evidence that any of the outside directors actually read it at any time. The outside directors did know, as well as the inside directors, that Credit was acquiring the assets of Mortgage through a merger and a stock issue. No outside director made any effort to ascertain the details of the transaction. Each outside director, including, of course, the outside directors defendants in this case, relied implicitly on the legal expertise of DeVennish and the accounting expertise of Hathaway and Hathaway and the financial expertise of Armel. There is no evidence in this case that any outside director actually knew that false statements had been included in the proxy solicitation. Specifically, there is no evidence at all that either Young or Patton knew either that the proxy solicitation was deficient or that the actual facts were different from the facts as stated in the solicitation. Insofar as actual fraud is concerned, it is the conclusion of this Court, based on all of the evidence in this case, that none of the defendants Young, Patton, Bolovan, or Tibbals did anything that was deceptive or manipulative. None of them did anything to ascertain the real facts, placing their reliance as above described. Even assuming the plaintiffs' burden to have been only by a proponderance, the plaintiffs failed to show by a preponderance of the evidence that Bolovan or Young or Patton or Tibbals had any "scienter."

As a result of the use of the proxy material, proxies necessary to the approval of the merger were obtained from the shareholders of Credit and also from the shareholders of Mortgage. The means by which they were obtained was the materially misleading solicitation. The proxy solicitation itself was an essential link in the accomplishment of the merger.

The plaintiffs showed, by a prepondersance, some damage as a result of the 10b5 violation. The only evidence in this case dealing specifically with the damage question was through an expert witness who testified that the most accurate way to value Mortgage stock prior to the merger was on a liquidating basis and that remained the same after the merger and presumptively they were the same. This Court does not agree for two reasons. In the first place, as already noted above, it has been indicated that the thrift certificates owned by Mortgage had some value and approximately $400,000.00 of its loans represented that in value, and whatever these values amounted to, they were lost to the Mortgage shareholders as a result of the merger. In the second place, there is a difference between the value of the Credit stock actually obtained in the merger and the real value which it would have had had the affirmative representations of the proxy statement been true.

Before turning to the legal conclusions applicable to the above, one defense — that of res judicata — was asserted as applicable only to the defendant Armel. In March of 1963 and just prior to the bankruptcy proceedings involving Credit, two of the three plaintiffs in this case, joined by some other plaintiffs, filed an action in this Court against Credit, Commonwealth Securities and a number of other corporations and, in addition, Armel, Young and Savage. Like this case, that action was described as one brought under Sections 10b, 15 and 27 of the Securities Act of 1934. It was brought as a class action on behalf of all stockholders of Certified Credit, including those who had obtained their stock as the result of the merger of Credit with Mortgage. Essentially the action was a derivative one, allegedly derived through Credit — the basic claim being that the defendants had conspired to obtain control of the assets of Credit basic-

ally through the A and B stock system and specifically through a number of devices and manipulations. The merger was described in paragraphs 45, et seq., as an act done in execution of the main conspiracy as was the merger proxy solicitation.

Shortly after the case was filed, and on April 2, 1963, Credit became a party to a Chapter 10 bankruptcy proceeding in this Court and promptly thereafter, the trustees entered the case and asked for a stay order. The general area of controversy was whether the action as filed was inside or outside the orbit of a Chapter 10, with the plaintiffs taking the position that some portions of the action as filed were non-derivative, were outside that orbit, and that at least as applied to such, the action should be permited to proceed. In 1963 the action was stayed. An appeal was filed and voluntarily dismissed by the appellants. Thereafter, and in 1968, this Court, on motion of the bankruptcy trustees, entered an order in that case substituting the trustee "as nominal party defendant for the defendant Certified Credit Corporation." That order also provided, "The subsequent prosecution of this case for the benefit of said estate shall proceed under his control." The defendant Young, was dismissed as a party by that order. Savage was thereafter dismissed without prejudice. Thereafter, and in 1969, an order was entered disposing of a motion by Armel to dismiss, which recited that "the within action be and it is hereby dismissed. Such dismissal shall be with prejudice.***"

With respect to this defense of res judicata asserted by Armel, the order in that case placing control of the litigation in the trustee for Credit, essentially determined that the matter would proceed only as a derivation case in which the controlling party would be asserting only derivative claims. The claims in this case are not derivative and were not disposed of in the previous litigation. Cf. *Simmons v. Wolfson*, F.2d (6th Cir. 1970).

The sole remaining fact question in this case is one of "good faith." Before reaching it, the conclusions of law of this Court are as follows:

(a) The proxy solicitation was used in connection with the purchase or sale of securities. Mortgage stock was purchased and Credit stock was sold in the merger. See *Mader v. Armel, supra* (6th Cir.)

(b) The proxy solicitation constituted a manipulative or deceptive device, contained untrue statements of material facts and, in addition, omitted the statement of material facts necessary in order to make the statements made not misleading in the light of the circumstances under which they were made. See *List v. Fashion Park,* supra. The proxy solicitation was in violation of 15 U.S.C. 78j and Rule 10b5.

(c) A causal relationship existed and exists between the violation and the injury sought to be redressed by this case. The proxy solicitation itself was in fact an essential link in the accomplishment of the transaction, since proxies necessary to approval of the merger were obtained by means of the solicitation. The evidence establishes that there was substantial proxy voting for the merger both by the shareholders of Credit and the shareholders of Mortgage—in addition, those voting in person had received and presumptively were influenced by the deficent proxies. See *Mills v. Electric Auto Light,* U.S. (1970).

(d) Armel clearly was aware of the misstatements in the proxy solicitation. Scienter, in the ordinary sense of the term, was clearly established as to Armel. For the reasons indicated above, the same is true of the defendant Savage. The proxy solicitation was authored by Armel and DeVennish.

While there is no showing that DeVennish, as such was personally aware of the falseness of the assertions contained in the proxy statement, he was aware of the materiality of the omissions. These conclusions with respect to Armel, Savage and DeVennish would be arrived at and are arrived at by the requirement of either preponderance or clear and convincing.

(e) No one of the remaining director-defendants, i.e., Bolovan, Young, Patton and Tibbals, personally used or employed any manipulative or deceptive device, nor did any one of them make any untrue statement of a material fact, nor did any one of them omit to state a material fact. None of them personally had anything to do with the proxy statement or any part thereof. Each of them relied on the Certified Public Accountant for the accuracy of the figures contained in the statement and each of them relied on counsel for the inclusion of all appropriate proxy material. No one of them had any expertise in matters of corporate accounting, let alone matters of intra-corporate accounting. None of them had any expertise in respect of the materiality of omissions.

(f) Essentially it is the claim of the plaintiffs with respect to these outside directors that each of them was a controlling person within the language of 15 U.S.C. 78t. That section, as has been noted, provides that any "person who, directly or indirectly, controls any person (Armel or DeVennish) liable under any provision *** shall be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable." Whether the outside directors were or were not directors of Mortgage

is not determinative of any question in this case. The outside directors were clearly directors of Credit and, to the extent liability devolves upon a director, a Credit director, under the statute as construed, would be as responsible to shareholders of Mortgage for misstatements in the proxy solicitation as would a Mortgage director. Some courts have gone to the extent of holding that a director as such is a controlling person with respect to a corporate president of counsel, since as a member of a board he clearly could exercise legal control over the president or counsel. The simple fact of the matter as applied to the Credit operations is that Armel was a "one-man show" who could not factually be controlled by anybody related to Credit. Even as applied to such a situation, there respectable authority concluding that a director is a controlling person. See *Moerman v. Zipco*, 302 *F.Supp.* 439 (E.C. N.Y., 1969) affirmed 422 F.2d 871 (2nd, 1970)—

"The conclusion is inescapable that persons who act as directors are in control of the corporation." See also *Myzel v. Fields*, 386 F.2d 718 (8th Cir., 1967). This, coupled with the tendency of some courts recently to expand liability from a strict scienter situation to a "negligence" situation (Cf. majority opinion in *Texas Gulf*, 401 F.2d 833 (2nd Cir. 1968))does approach the "frightening." That problem involves some differentiation between an injunction action and a damage action and has been described in *Heit v. Weitzen*, 402 F.2d 909 (2nd Cir., 1968) as a "thicket" and conclusorily in *Lanza v. Drexel* (S.D. N.Y. 1970), C.C.H. S.L.S. 92-826, in this manner:

"This is not to overlook the still clouded caldron in which the oracles continue to stew about scienter. In the present condition of all that,

however, it does not yet appear that anyone should be held liable, even for injunctive relief, let alone damages, unless there is at least a showing against him of 'lack of diligence, constructive fraud or unreasonable or negligent conduct.'"

Under the facts of this case, the thicket need only be entered in respect of the defendants Patton and Bolovan, who had been on the board a substantial length of time. The most that could be said of them from the plaintiffs' point of view is that they neglected to find out. While this Court would have no hesitancy in holding that a negligent director might well become involved in an injunction proceeding along with his more executive brothers, this Court is not prepared to say that a negligent director — a la 1959 — becomes liable, simply by virtue of the fact he was a director, for damages in a 10b5 case. Conclusorily, there is no showing that either Bolovan or Patton was a person in control.

(g) In respect of the defendant Young the thicket need not be entered. Technically, the proxy solicitation constituted an offer to exchange stock made by Credit. Whether one looks at the "controlled person" as Credit or its president and counsel, the simple fact of this case is that throughout the history of Credit, Armel, Dewey, Young and DeVennish constituted a control group for the purpose of controlling Credit and its officers, including Armel and DeVennish. Both the voting trust and the Certified Investment structure demonstrates that. The relationship of those named with Commonwealth Securities reinforces that demonstration. The controlling persons with respect to

Credit, and its proxy solicitation, made by mail to the shareholders of Mortgage, included the defendants Armel, DeVennish and Young—as well as Dewey.

(h) There remains the defense based on the last portion of 15 U.S.C. 78t, providing:

"... unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation."

Since Armel and DeVennish directly induced the act by preparing and releasing the proxy, the defense of good faith is not available to them. The defendant Young did nothing directly or indirectly to induce the proxy solicitation. In fact, he knew nothing about it before it was a fait accompli. The referenced portion of 78t has been applied rather consistently so as to eliminate from liability even persons in a control position—in accordance with the statute—whose actions overally bore the badge of innocence. Or as stated in *Lanza, supra,*

"A discriminating judgment on claims of good faith allows the court to weed out the genuinely innocent. That is as much as may fairly be asked by men who allow themselves to be installed in corporate office with power over, and ostensible responsibility for, the money of many other people."

The opposite of good faith is "bad faith." Bad faith certainly implies something more than negligence. Whether a director is paid or not paid has something to do with good faith or bad faith. That is not to say that it releases a director from responsibility—whatever that may be under the applicable state law. As a matter of fact, the defendant Young was a "for free" director of Credit at all times of interest here. Also bearing on good faith

is the experience of the individual in the responsibilities of the office. When Young became a director of Credit in the early 50's, it was his first directorship. True, he became a director of several other related companies, such as Commonwealth Securities, and of an independent company, Scioto Downs, prior to the period involved here. However, Credit was his first directorate and his first experience in a directorship was with a board operated obviously as a "one-man show." There is no question at all that he did not have the slightest idea anything was wrong with anything until some time in 1960 at the earliest. Up to then he relied fully of the Certified Public Accountants who bore a good reputation and he relied specifically on the annual published certification of those accountants; he relied strictly in law matters on DeVennish, who at all times has borne an excellent reputation and still does. He relied on Armel for financial matters and Armel, up until at least 1961, had an untarnished reputation in the financial field. Finally, and most importantly perhaps, the substantial investment of Young and his family in the Credit operation which continued through the events which gave rise to this case, speaks rather eloquently of his overall innocence. Young had the burden of showing "good faith" by a preponderance; he has sustained that burden, and it is this Court's conclusion that although he was a controlling person and although his performance as a director was negligent, his actions or non-actions were in good faith. As to him the complaint should be dismissed, as it should be with respect to the defendants Tibbals, Patton

and Bolovan. As to the defendants Armel, DeVennish and Savage, this Court concludes that liability as asserted in the complaint has been established.

The above satisfied the requirements of F.R.C.P. 52. Any party may submit requests for additional or amended findings within 30 days from the date of entry hereof, and after such time (and disposition of such requests, if such be made) a consistent judgment will be entered.

This is not a judgment. Counsel are requested, at the appropriate time, to prepare and present a judgment entry—

(a) dismissing the complaint at plaintiff's costs as to defendants Tibbals, Pattton, Young and Bolovan;

(b) finding the defendants Armel, Savage and DeVennish liable for such damage as may be established on further hearing of this case.

As to this (b) and in order to prevent piecemeal appeals of this case, the proposed judgment entry may and should contain (1) a certificate as set forth in 28 U.S.C. 1292b, and (2) the direction contained in F.R.C.P. 54(b), i.e., that the Court determines there is no just reason for delay in entering final judgments as aforesaid and such is expressly directed

/s/ Timothy S. Hogan
United States District Judge